LAW AND CONTEMPORARY PROBLEMS

THE NEW LOOK IN CORPORATION LAW

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FOREWORD

Not the least significant of the many factors that have contributed to the commercial and industrial pre-eminence that this country presently enjoys is the mode of organization that our business enterprise has come characteristically to employ. Early recognizing the limitations and drawbacks of less sophisticated techniques, and aided by a friendly—even inviting—legislative and judicial climate, the business community has warmly embraced and improvised upon the corporate form, whose versatility has thus far enabled it sensitively to respond to the needs of a dynamic economy. The concomitant separation of the elements of risk, control, and profit that this development has entailed, however, has posed, at least potentially, a serious threat to responsible investment and management. Regulatory legislation, accordingly, has universally been proposed and enacted, but the exact nature and extent of the restraints it should impose has caused considerable controversy.

Numerous theories, each mirroring a different conception of the appropriate role that government should play in this area, have been advanced. At one extreme, under the so-called "enabling act" theory, the privilege of incorporation would be made freely available, with a minimum of special conditions and limitations. Somewhat more restrictive is another theory whose adherents, although essentially persuaded of the social efficacy of enlightened self-interest, favor the interposition of legislative safeguards at critical junctures where experience has indicated that difficulties may arise. Another theory would, by legislative prescription, even more systematically impinge on freedom to contract, not only to protect investors and creditors, but to create and preserve the atmosphere of public confidence so necessary for business prosperity. And, finally, at the other extreme, the proponents of the so-called "social responsibility" theory urge that corporate power be exercised not primarily for the benefit of investors and creditors, or even customers and employees, but rather for the benefit of the general public.

The ideological dispute that these various rationales reflect has come into new prominence lately, with the almost wholesale re-examination and revision of corporation statutes that the past decade has witnessed. It is, therefore, to a more precise definition and evaluation of these competing philosophies, and to a survey of the manner and extent to which they have found expression in current legislation that the articles in this symposium have been addressed. In this connection, inquiry

has been directed to such basic matters as the roles of management and shareholders in corporate government; the substance and function of legal capital, surplus, and dividends; share characteristics; the fixity of class shareholders' rights; the rights of minority and dissenting shareholders in fundamental changes; the indemnification of insiders' litigation expenses; the special problems of the close corporation; and others.

No surprise, perhaps, will be occasioned by the revelation that, with a few notable exceptions, an "enabling act" philosophy continues to dominate corporation law in this country. Recent attempts at modernization—the "new look," if you will—although changing the appearance of the package in some respects, like Paris fashions, has left the fundamental contours largely unaltered. Whether or not this is a healthy situation, however, is a question on which our contributors have differed quite sharply—the academic lawyers seemingly taking a more critical attitude than their practicing brethren.

In these decisive times, when our own future and the future of the rest of the world may turn on the resilience and resourcefulness of our economic system, the role of the corporation, for better or for worse, in enabling it effectively to cope with the challenges that confront us may be crucial. It is, therefore, hoped that the ventilation of issues that this symposium affords will stimulate creative thinking about corporate problems and, at least in a small way, conduce their optimal solution.

MELVIN G. SHIMM.

THE PHILOSOPHY OF MIDCENTURY CORPORATION STATUTES

WILBER G. KATZ*

I

In the "New Look" title for this symposium, the Editor suggests a tempting figure of speech concerning fashions in corporation laws. He invites contributors to examine the models now on display and to describe what it is that constitutes the "new look." It might be entertaining to see how far one could spin out the fashion-show analogy. (One uninhibited commentator has, indeed, suggested that the contours of the American Bar Association's Model Business Corporation Act make it a seductive invitation to irresponsibility.[1]) My pen, however, is too heavy for such a task; and the Editor has used the term "philosophy" in defining my subject. What is expected from me, I take it, is a discussion of contemporary theories concerning the purposes of corporation statutes and the provisions appropriate for the accomplishment of those purposes. In trying to meet this assignment, it seems most promising to look not for theories embodied *in toto* in particular statutes, but for theories reflected in various statutes in different degrees and proportions.

The general purpose of incorporation statutes is to provide a particular legal mode for the organization of business enterprise. If we are to try to be "philosophical," we must begin at the beginning; we must begin with the concept of business enterprise and the function of the law of business organization. For our purposes, analysis of the concept of enterprise discloses three elements: *risk, control,* and *profit.* Problems of business organization are problems in the allocation of these elements among the parties to the enterprise. The law of business organization (agency, partnerships, corporations) is principally concerned with (1) defining the area within which parties are free to allocate risk, control, and profit as they wish, and (2) prescribing the allocation of these elements in the absence of express agreement.

I shall be interpreting the general problem of corporate legislation as a problem in regulating the allocation of these elements of enterprise so as to promote responsibility of investment and management. In the simplest type of business unit, the unincorporated one-man enterprise, no such problem arises. Risk, control, and profit

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[1] Harris, *The Model Business Corporation Act—Invitation to Irresponsibility?*, 50 NW. U. L. REV. 1 (1955).

are concentrated in the individual enterpriser. He operates under the general rules of contracts, torts, and property—rules which are backed up by remedial law, including the law against transfers in fraud of creditors. These rules, in effect, assign to the enterpriser (as profit or loss) the consequences of his business decisions. Since he thus takes the consequences, he has an incentive to act responsibly—*i.e.*, to act in the light of reasonable anticipations. To the extent that he does so, his actions are responsible in a broader sense also. Where enterprise is free and enterprisers act responsibly in their own interests, they are led by market disciplines to serve the social interest as well. For our purposes, we need not spell out why this is so, since discussions of the modern corporation invariably assume that individual enterprise has this desirable characteristic. What such discussions question is the relevance of this analysis to the large corporation, with its separation of ownership from control.

It is not only the corporate form of organization, however, which creates problems concerning separation of the elements of enterprise. Such problems arise as soon as the enterprise makes use of employees. Basic rules of agency law deal with these problems and are best understood, it seems to me, as efforts to prevent such separation of risk, control, and profit as would jeopardize responsible management. The rule *respondeat superior,* always difficult to justify on ordinary tort principles, is understandable as an effort to place the risks of the enterprise upon the enterprise, to require the enterpriser to weigh such risks in making his business calculations. Similarly, the liability of the undisclosed principal, which is hard to explain on contract principles, represents an effort to assure responsibility in the decisions made by the owner of a business, to make it impossible for the owner to hide behind an irresponsible agent. This explanation applies also to the common-law liability of secret partners. Furthermore, the rules establishing agents' fiduciary duties and disabilities represent attempts to promote responsible action by agents in the interest of their principals. Again, the rule that agency powers are ordinarily revocable, even when stated to be irrevocable, represents another striking effort to check the irresponsible action which might result from irrevocable separation of risk and control. This interpretation explains also the exception to this rule in the case of powers coupled with an interest or powers given as security. The exception permits one who thus participates in the risks of the enterprise to be given irrevocably a share in its control.

These rules reflect concern lest responsible management be jeopardized by arrangements separating risk, control, and profit. They leave great freedom, however, for the allocation of these elements. For example, one who lends money or sells goods to a partnership may agree to look solely to partnership assets, thus assuming a share of the enterprise risk. A lender may agree to take a share of the profits in lieu of interest, or an employee may do so in lieu of fixed salary. They thus become participants in both the profits and the risks of the enterprise, but without sharing the liability of partners. The variety of these voluntary arrangements for sharing risk, control, and profit is enormous. As already indicated, a primary function of

the law of business organization is the setting of limits to the possible variations. When the corporate form of organization is made available by statute, the principal legislative question is whether there are special threats to irresponsibility inherent in the corporate form which require special restraints on the freedom to allocate risk, control, and profit. "Philosophies" of corporate statutes reflect divergent answers to this question. Some of these theories will first be stated briefly; in the next part, representative statutory provisions will be examined to ascertain the relative influence of the various theories; and then we should be in a position to consider whether there is a dominant philosophy of the "new look."

1. The first contemporary theory which I shall consider is the theory that a corporation statute should be merely an "enabling act." Under this theory, the privilege of incorporation with "limited liability" should be made freely available, and promoters should have freedom in defining the scope of the enterprise and in allocating risk, control, and profit through the corporation's security structure. This theory prescribes also that relatively unhampered procedures should be available to meet changing conditions by effecting changes in corporate purposes and security structures.

No special conditions on the use of the corporate form are deemed necessary. This theory implies that decisions for commitment of funds are the individual responsibility of the investor or lender, protected, however, by the law of deceit. Adherence to the agreed allocation of risks is deemed adequately assured by the rules of contracts and fraudulent conveyances; management loyalty is adequately promoted by the rules concerning fiduciary duties and disabilities. This theory reflects also a skepticism as to the effectiveness of protective devices suggested by alternative theories. It is feared also that incomplete legislative protections may result in relaxation of individual efforts at self-protection, efforts which are deemed indispensable if investment decisions are to be responsibly made.

Advocates of the "enabling act" theory reject the notion that a corporation statute should deal with the problem of possible monopoly. This theory, therefore, calls for no limitations of size, duration, purposes, or general powers.[2]

The "enabling act" theory does not mean that an adequate corporation statute can be simple and brief. To serve effectively as an enabling act, it must make its grants of power and its authorized procedures sufficiently detailed to minimize doubts, including doubts which might arise from previous statutes and their judicial interpretation.

2. The second theory, like the first, is grounded on the premise that the social interest is best served through responsible individual decisions in the furtherance of individual interests. The second, however, reflects a belief that for corporate organization, the basic common-law doctrines of contracts, torts, and agency are inadequate to assure responsible individual decision, that these doctrines should be elab-

[2] Recent corporation statutes show almost no traces of the general restrictive theory of which the classical statement is the opinion of Mr. Justice Brandeis in Louis K. Liggett Co. v. Lee, 288 U.S. 517, 541 (1933).

orated and supplemented at various points to make it less likely that agreements as to division of risk, control, and profit may be inadvisedly made or ineffectually implemented.

For example, to provide a setting for responsible individual decision, a corporation statute may include detailed provisions as to the relative rights of creditors and shareholders, and of holders of different classes of shares—provisions which leave the parties free to determine these rights, but which formalize the way in which the determination must be made and which provide rules applicable in the absence of contrary determination by the parties. A statute drawn on this theory might spell out the application of the law of deceit in the corporation setting. It might go further and relieve lenders and investors of the burden of asking the appropriate questions, creating affirmative duties of disclosure in order to make it more probable that decisions as to commitment of funds, exercise of voting rights, etc. will be responsibly made. Such a statute might also codify other general rules in their particular application to corporate organization, such as the rules prescribing fiduciary standards of loyalty and prohibiting transfers in fraud of creditors. In such codification, the rules might be strengthened to block evasion opportunities peculiar to the corporate situation. In short, the second theory still looks to individual decisions made with responsibility, but it advocates the creation of a statutory setting fostering such responsibility.

3. The third theory prescribes a more drastic remedy, lest risks be inadvertently assumed and powers inadvisedly exercised. It prescribes restrictions on the freedom of the parties to allocate risk, control, and profit by contract. It conceives the task of the legislature as including that of identifying particular types of allocation which are deemed to jeopardize responsible investment and management. For example, the statutes might outlaw nonvoting stock, prescribe a specified margin of safety for creditors, or require more than a simple majority vote for various corporate readjustments.

A point should be added which is applicable to both the second and third theories. Their purpose in attempting to check irresponsible enterprise may be not only to protect the investors and creditors directly involved, but also to reduce the likelihood of financial catastrophes which might destroy the climate of reasonable confidence which business enterprise requires.[3] But whichever may be the dominant motive, the statutes are designed to promote responsible decisions in the interests of investors and creditors. Since the third theory attempts to do this by limiting the area of permissible arrangements, it may fairly be called a "paternal responsibility" theory.

4. The fourth theory is a theory of "social responsibility." Its adherents disparage the foregoing theories as all but irrelevant to the large corporation with its wide dispersion of ownership among inactive stockholders. It is asserted that manage-

[3] Examples of this theme can be found in the writings of Jerome N. Frank and William O. Douglas. See dissenting opinion of Commissioner Frank in In the Matter of The North American Company, 4 S.E.C. 434, 462 (1939); WILLIAM O. DOUGLAS, DEMOCRACY AND FINANCE (1940).

ment neither can nor should be made wholly responsible to stockholders. Absentee owners who have abdicated control have no ethical basis for a claim that the enterprise be conducted to maximize their return. Furthermore, in many industries, so large a fraction of the business is said to be concentrated in a few large corporations that consumers are inadequately protected by market competition. Similarly, where a single plant employs a large fraction of the labor force of the locality, it is argued that alternate employment opportunities furnish inadequate protection against management decisions to reduce operations or to relocate. It is urged that corporate managers should be under no obligation to maximize profit, but should have a wider responsibility; that they should exercise corporate powers in the interest not only of shareholders, but also of employees, customers, and the "general public." While this theory has been much discussed by philosophers of corporation law, it has almost no reflection in the actual statutes. The one exception is the wide adoption of provisions authorizing corporate gifts to charity. Professor Berle considers the charitable-gift statutes as showing the direction of a "20th Century Capitalist Revolution."[4] We shall consider other statutory changes which a "social responsibility" theory might support after we have reviewed the way in which midcentury statutes deal with a representative group of problems and after we have attempted to measure the influence of the first three theories.

II

1. *Creditors' margin of safety*

Nineteenth-century corporation statutes embodied in various ways the concept of a capital fund, or margin of safety, for creditors as a substitute for the personal liability of shareholders. The amount of the margin was the par value of the shares issued. The margin requirement was implemented, in varying degrees of effectiveness, by provisions making subscribers liable for the full amount of the par value and protecting this "capital" against impairment through dividends or purchase of outstanding shares. Some of the statutes prescribed a maximum ratio of debt to stock investment, but these provisions were gradually eliminated and the amount of the creditors' margin left to the will of the incorporators, except for a purely nominal flat minimum. American statutes were, thus, similar to the British Companies Act which W. S. Gilbert lampooned in *Utopia, Ltd.* According to Gilbert, the statute required of incorporators nothing more than "a public declaration to what extent they mean to pay their debts."

The American statutes often left serious gaps in the implementation of the margin-of-safety concept. There were sometimes no teeth in the requirement that the capital be paid in, and provisions as to maintenance of capital were commonly incomplete. Of more importance, there were often provisions authorizing reduction of capital without any restriction for protection of existing creditors such as the British requirement of court approval. Authorization of no-par value shares intro-

[4] ADOLF A. BERLE, JR., THE 20TH CENTURY CAPITALIST REVOLUTION 164, 168 *et seq.* (1954).

duced further complexities and doubts. While most of the statutes probably left some place for "stock-watering" liability on no-par value shares, it was doubtful whether the shareholders were required to underwrite the valuation of the entire consideration for their shares or only the portion labeled "stated capital," excluding any amount allocated to "paid-in surplus." This became an important question as to par value shares also with the advent of the current practice of issuing shares with an arbitrarily low par value and a large paid-in surplus.

Following the Model Act as revised in 1955,[5] several recent statutes have cleared up the confusion as to paid-in surplus. This has been accomplished by requiring that the consideration for shares, whether par or no-par value, shall be fixed in dollars and by imposing shareholders' liability in terms not of par or stated value, but of the full consideration fixed for the shares (subject to good faith valuation of property transferred in payment). The same statutes, however, often leave creditors without protection against distributions in "partial liquidation," even to the extent of the stated capital.[6] The extension or clarification of stock-watering liability in these statutes cannot, therefore, be interpreted as an implementation of the margin-of-safety notion, but merely as an effort to check the obtaining of credit through an intentionally misleading balance sheet.

As already suggested, twentieth-century statutes have often permitted formal reduction of capital without protection of existing creditors. Several recent statutes, following the Model Act, have abolished even the necessity of formal reduction and have authorized dividends *out of stated capital* in partial liquidation if the articles so provide or if shareholder vote is secured.[7] The limit to such distribution is reached only at the point of insolvency, which is usually defined in recent statutes as an inability to pay debts as they mature in the usual course of business.

Some of the recent statutes, however, retain and revitalize the margin-of-safety concept. Thus, neither Texas nor North Carolina authorizes distributions directly "out of" stated capital, and both put restraints upon distribution of surplus created by reduction of stated capital. Texas dramatically departs from the Model Act by providing that distributions of reduction surplus shall make directors liable to creditors existing at the time of the reduction in the event of later insolvency.[8] North Carolina requires that any distribution of capital surplus (including reduction surplus) must leave assets at least twice the amount of the debts.[9] Both of these statutes appear designed to block distributions which would subject creditors to risks which they might not reasonably anticipate. The Texas provision establishes a limit to creditors' risks in terms of stated capital, but the stated capital may be fixed at an

[5] MODEL BUSINESS CORPORATION ACT §§ 17, 23. The Model Act has been published as COMMITTEE ON CORPORATE LAWS, AMERICAN BAR ASSOCIATION, MODEL BUSINESS CORPORATION ACT (1953). The 1955 revisions and optional sections appear in a supplemental leaflet. *Id.*, REVISIONS AND OPTIONAL SECTIONS (1955).

[6] *Cf.* MODEL BUSINESS CORPORATION ACT § 41.

[7] *Ibid.*

[8] TEX. BUS. CORP. ACT art. 2.41A(6) (1956).

[9] N.C. GEN. STAT. § 55-50(e)(3) (Supp. 1955).

arbitrary minimum. The North Carolina provision cannot be reduced to nominal effect, since it covers not only stated capital, but also capital surplus; the margin originally fixed may be reduced, however, so long as there remains a margin of 100 per cent over debts. None of the statutes contains any substantial requirement of original junior investment.

In this field, therefore, none of the statutes reflects the "paternal responsibility" theory, as do the Public Utility Holding Company Act and chapter ten of the Bankruptcy Act, with their control of debt-equity ratios.[10] What the recent statutes do, in varying degrees, is to protect a margin once established or purported to have been established. They thus illustrate my second theory, clarifying the original agreement or representation as to risk and providing relief by adapting general principles of contracts or deceit. But since most of the statutes take few steps in this direction, they illustrate basically the first or "enabling act" theory, leaving it to creditors to make their own bargains for the limitation of their risk. As a result, elaborate covenants restricting dividends and other distributions and share purchases are now common features not only of bond and debenture indentures, but also of other types of agreements for extension of credit.

2. *Promotion and security flotation*

Apart from statute, courts have imposed upon corporate promoters duties beyond those established by the common law of deceit. Promoters have been held to be fiduciaries subject to an affirmative duty of disclosure, for breach of which the corporation may, in certain situations, recover. But it has been open to the promoter to avoid this result by having all the shares issued initially to himself, with sales to the public made by him rather than by the corporation. In this situation, the promoter is free from common-law liability, unless his conduct amounted to deceit. It is usually not difficult to arrange the promotion transactions in the form which thus minimizes risk of liability.

The recent North Carolina statute is unique in closing this loophole. It includes within its definition of "watered shares" (which are made subject to cancellation or assessment) all shares issued to promoters for overvalued property which unfairly dilute the holdings of other shareholders to whom adequate disclosure has not been made.[11] Thus, in North Carolina, corporation lawyers can no longer defeat the requirement of disclosure by mere technical arrangement of promotion transactions.

Draftsmen of other corporation statutes have ignored this problem, perhaps because the separate securities acts or "blue sky" laws provide statutory remedies for purchasers of stock. While these statutes are beyond the scope of this symposium, one point may be noted as to how they illustrate the general theories considered in this paper. This is the familiar contrast between the Federal Securities Act of 1933

[10] 49 STAT. 815 (1935), 15 U.S.C. § 79g (1952); 52 STAT. 895, 897 (1938), 11 U.S.C. §§ 616, 621 (1952).

[11] N.C. GEN. STAT. § 55-53 (Supp. 1955).

and the typical state securities law. The federal act, like the North Carolina promoters' profit provision, is a disclosure act; it thus illustrates my second theory, supplementing and reinforcing the law of deceit in order to promote responsible investment. The state securities acts, on the other hand, usually vest in their administrators discretionary power to halt the sale of securities which are deemed to be "inequitable" or which would "tend to work a fraud." For example, under these statutes, maximum selling commissions are often established and particular types of financing arrangements are forbidden. Such provisions illustrate, or course, my third, or "paternal responsibility," theory. Even the SEC, furthermore, exercises influence on the terms of security flotations not only through its disclosure requirements, but also by conditioning the exercise of its discretionary power to accelerate registration upon compliance with certain approved standards.[12]

3. *Fiduciary duties and their enforcement*

Application to corporate officers and directors of the agency standards of fiduciary loyalty has generally been accomplished without the aid of statute. Legislation in this field, however, has been on the increase. A few of the statutory provisions have tightened fiduciary standards. Several recent statutes have flatly forbidden all loans to officers and directors. A few have facilitated derivative suits by subjecting nonresident directors to jurisdiction on constructive service. In general, however, there has been little effort in state legislation to keep corporate fiduciaries away from temptation. State legislatures have not followed the federal lead with devices like the recapture of profits from "short-swing" stock trading[13] or in extending fiduciary duties to dealings with individual shareholders.[14] Some of the recent statutes may have actually reduced the force of the common-law rules. For example, many state courts have declared that transactions authorized through the vote of a director adversely interested are voidable *regardless of fairness*. The North Carolina statute, however, provides that a transaction shall not be set aside if proved to have been "just and reasonable to the corporation" at the time it was approved.[15] Several recent statutes, furthermore, authorize the fixing of executive compensation without a disinterested majority in the board and without shareholder ratification. There have been several provisions authorizing stock option plans for executives. Some of these have followed the Model Act optional provision which requires approval by shareholders.[16]

With respect to enforcement of fiduciary duties through shareholders' derivative suits, recent statutes are primarily concerned with the "strike suit" problem. They continue the trend toward the rule disqualifying plaintiffs who were not shareholders at the time of the alleged wrong. The recent statutes typically authorize

[12] Note to SEC Rule 460, Securities Act Release No. 3791, May 28, 1957.
[13] *Cf.* Securities Exchange Act of 1934, § 16(b), 48 STAT. 896, 15 U.S.C. § 78p(b) (1952).
[14] *Cf.* SEC Rule X-10B-5, 17 C.F.R. § 240-106-5 (1949).
[15] N.C. GEN. STAT. § 55-30(b)(3) (Supp. 1955).
[16] *Cf.* MODEL BUSINESS CORPORATION ACT § 18A.

indemnification of defendant directors for litigation expenses in cases where the litigation is settled as well as where defendants are judicially exonerated. Most of these provisions follow the Model Act in rejecting both the California requirement of court approval and the New York requirement of reporting to shareholders.[17] The North Carolina statute, however, does require court approval.[18]

A few of the recent statutes include provisions for posting by shareholder-plaintiffs of security for litigation expenses of defendants. Wisconsin gives defendants a right to such security from plaintiffs holding less than three per cent of the shares of any class.[19] North Dakota enacts the Model Act optional provision under which no security may be required of plaintiffs whose holdings exceed $25,000 in market value.[20] A companion provision authorizes the court, at the end of any derivative suit, to require plaintiffs to pay defendants' expenses if the court finds that the action was brought without reasonable cause.[21]

On balance, the recent legislation concerning fiduciary duties illustrates the "enabling act" theory, since its major concern has been lest application of common-law doctrines should be unduly restrictive of corporate management.

4. *Election of directors*

Most American statutes have not regulated the allocation of voting rights as a means of promoting management responsibility to those bearing the ultimate risk. To be sure, provisions for removal of directors, with or without cause, are increasingly common. Removal action, however, can be taken only by shareholders with voting rights, and all of the recent statutes permit denial of voting rights to any class or classes of shares. The statutes have no general requirement of "equitable" distribution of voting power like those of the Holding Company Act and chapter ten of the Bankruptcy Act.[22] Nonvoting common shares are permissible, and exclusive voting control may thus apparently be vested in a small, closely-held class of "management shares" representing only nominal investment. Furthermore, express authorization of voting trusts is now customary, usually limited to ten years' duration, but without time limit under the Wisconsin statute.[23] The importance of the statutory freedom to separate risk and voting control is somewhat reduced, however, by the fact that the New York Stock Exchange refuses to list nonvoting common shares. Mandatory cumulative voting to permit minority representation is provided in the Ohio[24] and North Carolina[25] statutes and in the original Model Act.[26] These statutes reflect a belief that, on balance, responsible management is

[17] *Cf. id.* § 4(o). *But see* CAL. CORP. CODE § 830; N.Y. GEN. CORP. LAW § 63.
[18] N.C. GEN. STAT. § 55-21(a)(2) (Supp. 1955).
[19] WIS. STAT. § 180.405(4) (1955).
[20] N.D. Laws 1957, c. 102, § 44; *cf.* MODEL BUSINESS CORPORATION ACT § 43A.
[21] *Ibid.*
[22] *Cf.* note 10 *supra.*
[23] WIS. STAT. § 180.27 (1955).
[24] OHIO REV. CODE ANN. § 1701.55 (Page Supp. 1956).
[25] N.C. GEN. STAT. § 55-67(c) (Supp. 1955).
[26] MODEL BUSINESS CORPORATION ACT § 31.

promoted by providing this channel of criticism, notwithstanding the dangers of dissension within the board. Most of the states following the Model Act have chosen the alternative provision for permissive cumulative voting.[27] Massachusetts, however, has recently repealed its permissive provision and now has no authorization.[28]

5. *Preferred shares*

". . . preferred stockholders are not—like sailors or idiots or infants—wards of the judiciary."[29] This dictum of Judge Frank was pronounced in a case involving "non-cumulative" preferred stock. Paraphrasing Gertrude Stein, he insisted: ". . . a contract is a contract is a contract."[30] To what extent, we may ask, do preferred stock provisions of midcentury corporation statutes reflect a similar philosophy? To what extent, on the other hand, have preferred stockholders become wards of the legislature? The North Carolina statute has gone farthest in the latter direction. I shall summarize the principal provisions which support this statement and indicate some of the contrasts afforded by other statutes.

Before this is done, however, it should be noted that the North Carolina statute has also some unique provisions designed to obviate troublesome problems of interpretation without limiting contractual freedom. It is provided that preferred shareholders are excluded from participating beyond their stated preferences (dividend and liquidation), unless the language clearly indicates the contrary. Similarly, the amount of any dividend arrearage is to be added to the stated liquidation preference, unless this result is clearly inconsistent with the charter wording.[31]

None of the state statutes approaches the kind of standardization of preferred-stock provisions and regulation of capital structures which the Securities & Exchange Commission has developed under the Public Utility Holding Company Act. No state requires, as do these SEC regulations, that holders of preferred stock be empowered to elect a majority of the directors when dividends are in arrears; nor do the state statutes regulate the ratio of preferred to common stock investment.[32] The North Carolina statute, however, does provide that, regardless of charter language, non-cumulative preferred shareholders shall be entitled to a "dividend credit" to the extent that their dividends are earned but not declared in any year.[33]

Another unique provision of this statute enables preferred shareholders to protect themselves against distributions of capital surplus to common shareholders in partial liquidation. Such a distribution requires a majority vote of each class.[34] (There is no corresponding restriction, however, on the use of the same funds to purchase common shares.) The statute also contains a general prohibition of dividends and

[27] *Cf. id.* alternative § 31.
[28] Mass. Laws 1956, c. 375.
[29] Guttmann v. Illinois Central R. Co., 189 F.2d 927, 930 (2d Cir. 1951).
[30] *Ibid.*
[31] N.C. GEN. STAT. § 55-40(b) (Supp. 1955).
[32] *Cf.* 49 STAT. 815 (1935), 15 U.S.C. § 79g (1952). See also Public Utilities Holding Company Act Release No. 13106, Feb. 16, 1956.
[33] N.C. GEN. STAT. § 55-40(c) (Supp. 1955).
[34] *Id.* § 55-50(e)(1).

purchases of shares if the action would reduce net assets to an amount below the aggregate liquidation preferences of preferred shareholders.[35]

Contemporary statutes deal in increasing detail with changes in the position of preferred shareholders through charter amendment, merger, etc. They typically contain express authority for cancellation of arrearages but require approval by preferred shareholders voting as a class, even if the class has no voting rights in elections of directors. Following Delaware, North Carolina requires only a simple majority of the class,[36] while the Model Act requires two-thirds.[37] The North Carolina statute adds a caveat: "No inference shall be drawn from the broad power of amendment conferred by this chapter that an exercise of that power in a particular case is fair and equitable."[38] Contrary to the Model Act, appraisal rights are given to dissenting preferred shareholders in certain cases of charter amendment as well as merger;[39] and an appraisal floor is set at two-thirds of the liquidation preference if junior shares participate in the plan without contribution.[40]

The North Carolina draftsmen removed one of the sources of the pressure sometimes exerted upon preferred shareholders to agree to a reduction of their rights. In states where dividends out of current earnings are forbidden when capital is impaired, payment of preferred dividends may require a reduction of capital, which common shareholders are in a position to block. The North Carolina statute not only permits payment of preferred dividends out of current profits when capital is impaired, but also makes this provision override any charter limitation to the contrary.[41] Purchases of preferred shares at prices depressed by suspension of dividends are somewhat restricted by the requirement of prior notice of intention to make such purchases.[42] Under the Texas statute, no shares may be purchased when dividends are in arrears.[43]

Most of the recent statutes have no similar provisions restricting the allocation of risk, control, and profit among holders of various classes of shares. They leave it to investors in preferred shares (as they do to creditors) to bargain out acceptable protective provisions.

III

The foregoing summary makes clear that the recent statutes reflect, in general, an "enabling act" theory, more or less modified by the theory that corporation statutes, while assuring freedom of contract, should reinforce in various ways the responsibility of individual decisions; and the theory that freedom of the parties should be limited in order that the results of responsible freedom may more nearly

[35] *Id.* § 55-50(c)(3).
[36] *Id.* § 55-100(b)(3); *cf.* DEL. CODE ANN. tit. 8, § 242 (1953).
[37] MODEL BUSINESS CORPORATION ACT § 54(c).
[38] N.C. GEN. STAT. § 55-99(a) (Supp. 1955).
[39] *Id.* § 55-101(b). But *cf.* MODEL BUSINESS CORPORATION ACT §§ 71, 74.
[40] N.C. GEN. STAT. § 55-113(e) (Supp. 1955).
[41] *Id.* § 55-50(b).
[42] *Id.* § 55-52(f).
[43] TEX. BUS. CORP. ACT art. 2.03C (1956).

be approximated. Only the North Carolina statute has gone very far in applying these latter theories; it thus has a kind of "new look" which is conspicuous in the parade of new statutes.

Apart from this almost unique design, what is there in the other recent statutes, particularly those patterned after the Model Act, which justifies the term "new look"? It is sometimes suggested that the novelty of design is to be appreciated by contrasting the Delaware General Corporation Law. A principal draftsman of the Model Act reported the opinion of the American Bar Association Committee that the Delaware Act is[44]

> poor in sequence and loose in its provisions. . . . [It] bids for the corporate business of promoters. It makes little or no effort to protect the rights of investors. Hence, in the opinion of the committee, it was not the type of statute which the committee should present as a model. . . . The model act makes use of only one provision of the Delaware statute and that is the provision empowering corporations to indemnify their directors. . . .

This quotation seems to me to exaggerate the differences in substance between the Delaware and Model acts. The examples of "loose" Delaware provisions cited in this article are those permitting charter amendment by simple majority and permitting dividends from current earnings notwithstanding a capital deficit.[45] Neither of these features seems conspicuously "loose"; both are incorporated in the new North Carolina statute,[46] the draftsmen of which were certainly solicitous of the interests of investors. There are, of course, other provisions of the Delaware statute which are open to criticism, such as the authorization of dividends out of capital surplus with no requirement that the source be identified.[47]

The most important contrast between the Delaware and Model acts is that indicated by the statement that the Delaware statute is "poor in sequence." At the time the Model Act was prepared, the Delaware Act was exceedingly difficult to use because of its lack of convenient arrangement and its long, involved sentences. In the revised Delaware Code of 1953, the General Corporation Law was improved by breaking up and rearrangement of sections, but unwieldy sentence structure still predominates. The Model Act has, indeed, a new look: it is vastly easier on the eyes. (Some of my friends out here in the provinces say that it's the difference between Chicago and New York styles of corporate draftsmanship.)

IV

We have seen that a more or less unmodified "enabling act" philosophy is dominant in most of the recent corporation statutes, as it is in the Delaware statute. It is a curious fact, however, that this philosophy is seldom articulated and almost never defended with confident vigor. Its objective—responsible management in the inter-

[44] Campbell, *The Model Business Corporation Act*, Business Lawyer, July 1956, pp. 98, 100-01.

[45] DEL. CODE ANN. tit. 8, §§ 242, 170 (1953).

[46] N.C. GEN. STAT. §§ 55-101, 55-50 (Supp. 1955).

[47] DEL. CODE ANN. tit. 8, § 170 (1953).

ests of shareholders—has been under attack for over a generation. The attack has come from many sources—from social philosophers and theologians, from economists and law teachers and business executives.

This movement began with Thorstein Veblen, who caustically depicted the modern corporation, with its inactive stockholders, as a prime example of "absentee ownership."[48] Of greater importance, perhaps, were the pronouncements of corporation executives in the twenties, heralding a new orientation of management loyalty. Henry Ford, in trying to defend his limited dividends against minority stockholder attack, disclaimed any intention to maximize profits and proposed, instead, to reduce prices for the benefit of car buyers and to create more jobs. While the Supreme Court of Michigan flatly rejected this view of corporate purposes,[49] other leading executives espoused the same philosophy. Owen D. Young wrote that he considered himself a trustee not merely for stockholders, but for the corporate "institution"—*i.e.*, for stockholders, employees, customers, and the general public.[50]

In 1932, Adolf A. Berle and Gardiner C. Means, in *The Modern Corporation and Private Property,* gave strong support to this idea, and their work was widely hailed as a contribution of outstanding importance. Tracing the extent of the separation of ownership from control in the modern corporation, they challenged the ethical claim of the inactive investor to the residual profits of industry. They declared that[51]

> it seems almost essential if the corporate system is to survive,—that the "control" of the great corporations should develop into a purely neutral technocracy, balancing a variety of claims by various groups in the community and assigning to each a portion of the income stream on the basis of public policy rather than private cupidity.

True, when Professor E. Merrick Dodd called for legal recognition of the new principle of wider responsibility, Professor Berle suggested caution.[52] In rejoinder, Dodd insisted that a principle of "vicarious acquisitiveness" has little ethical or emotional appeal either to managers or to the general public. For Dodd, the principle of trusteeship for absentee investors presented a melancholy dilemma: "Abandon it as yet, we dare not—enforce it with more than moderate success, it is to be feared we cannot."[53]

I have said that the "social responsibility" philosophy has had almost no influence upon recent statutes. The one exception is the now popular authorization of corporate gifts to charity. Even before these statutes, of course, many types of donations were defensible as means of creating consumer or employee goodwill. The recent

[48] THORSTEIN VEBLEN, ABSENTEE OWNERSHIP AND BUSINESS ENTERPRISE IN RECENT TIMES c. V. (1923).

[49] Dodge v. Ford Motor Co., 204 Mich. 459, 505-06, 170 N.W. 668, 683-84 (1919).

[50] Quoted in JOHN H. SEARS, THE NEW PLACE OF THE STOCKHOLDER 208-10 (1929).

[51] P. 356.

[52] Dodd, *For Whom Are Corporate Managers Trustees?* 45 HARV. L. REV. 1145 (1932); Berle, *For Whom Corporate Managers Are Trustees, id.* at 1365.

[53] Dodd, *Is Effective Enforcement of Fiduciary Duties of Corporate Managers Practicable?* 2 U. CHI. L. REV. 194, 207 (1935).

statutes, however, cover much broader ground. The pressure for corporate giving was a result of tax laws which made it increasingly difficult to finance charities through individual gifts. Congress was induced to provide a limited tax deduction for corporate donations.[54] One cannot dismiss the state statutes, however, as merely dealing with a tax problem. They do represent a limited acceptance of the social responsibility theory, as the New Jersey court recognized in the leading case.[55] Many of the recent statutes, furthermore, have set no limits upon corporate gifts, either in terms of amount or of shareholder approval. Ohio has recently repealed its previous limitations.[56]

As already noted, Professor Berle considers that these statutes are signs of a corporate revolution. Magnanimously, he now concedes victory to Professor Dodd in their 1932 controversy over "To Whom Are Corporate Managers Trustees?"[57] I find it hard to believe that the charitable-gift statutes and practices will prove to be forerunners of a major change. Under the traditional view, risk-taking investment is typically made in the hope not only of cash dividends, but also of appreciation reflected in stock prices and often "realized" through stock dividends and splits with gradually increasing total cash distributions. I see no reason to think that this concept of common stock is soon to be replaced by a concept under which the expectation of stockholders will be limited, like that of holders of perpetual debentures, with no claim upon residual profits. Corporate giving may increase, but it is unlikely that whatever profits are left after "reasonable dividends" will come to be regarded as at the disposal of the directors in accordance with their views of public welfare.

Apart from these provisions for charitable contributions, the new concept of social responsibility has had almost no elaboration. It is not merely that the theory has had no further influence on the actual statutes, but in a quarter of a century, neither the originators of this philosophy nor their disciples have sketched with any detail or persuasiveness the lines of possible practical application. And the few suggestions which have been made justify skepticism as to the seminal quality of the new theory.

In 1954, George Goyder, an English businessman, published *The Future of Private Enterprise—A Study in Responsibility*. In his view,[58]

> The weakness of Company Law at present is that the directors are without legal guidance as to their responsibilities to the workers, the consumers or the community. . . . What is wanted is a *General Objects Clause,* declaring management responsibility for "fair and reasonable prices," "regular dividends," "stable employment under good conditions so far as possible," etc. Once defined, the legal responsibilities . . . of the directors, can be made actionable in a court of law, . . .

[54] INT. REV. CODE OF 1954, § 170(b)(2).
[55] A. P. Smith Mfg. Co. v. Barlow, 13 N.J. 145, 98 A.2d 581 (1953).
[56] OHIO REV. CODE ANN. § 1701.13(D) (Page Supp. 1956). *Cf. id.,* § 1702.26 (Page 1953).
[57] BERLE, *op. cit. supra* note 4, at 169.
[58] Pp. 92-93.

Nothing could be simpler; but the history of utility regulation and of emergency price and wage controls is soberingly relevant. To say the least, standards of "fair" prices and wages are hard to come by, and few lawyers can be optimistic about the litigation process as a mode of developing such standards.

More cautious is the approach of Howard R. Bowen in *Social Responsibility of the Businessman,* part of a study commissioned by the Federal Council of Churches and published in 1953. Dr. Bowen endorses the "social responsibility" concept, but, as an economist, he recognizes that businessmen[59]

> are often not in a good position to know how they can best serve society, and their decisions based on the service motive may often hit wide of the target. . . . They need short-cut methods of reaching decisions that do not involve all the complexities of relating every individual action to the social interest. The price system provides that short-cut method. With all its imperfections, it is a marvelous device for registering social valuations and thus providing a system of easily recognizable signals by which individuals can reconcile their own self-interest and the social interest. . . . [Thus, the businessman should] rely primarily on profit as his guide. . . . [He should depart from this guide only when it leads him toward] restrictive monopoly, exploitation, fraud, misrepresentation, political bribery, waste of natural resources, economic insecurity, etc.

Here, again, these terms offer little guidance to the conscientious director (except as to misrepresentation and other conduct forbidden by law).

In general, one may question the extent to which socially responsible deliberation would actually lead management to decisions different from those indicated by long-range profit considerations. For example, concern for employee goodwill might well cause management to seek ways to cushion the effects of production cut-backs, automation, plant relocation, etc. If advocates of "social responsibility" would have management go much farther in maintaining unprofitable operations, it is by no means clear that such action would be socially responsible. And with respect to price policy, however seriously management might regard its social responsibility, perhaps the influences operating to further the social interest would still be principally those resulting from competition among products and producers for consumers' spending.[60] In any event, management must be concerned with the extent to which the new concept of corporate responsibility may influence behavior of consumers or employees. If public opinion comes to expect corporations to assume some new responsibility, this is a fact which profit-conscious management can not ignore.

Another "reform" proposed in the name of social responsibility is the abolition of shareholder voting rights. This is a measure advocated by Peter F. Drucker after a period as official philosopher-in-residence at General Motors. According to Drucker, "there is absolutely nothing in the nature of investment that either requires or justifies ownership rights, that is rights of control"; voting power should

[59] Pp. 144, 146.

[60] In any event, one would not be unduly skeptical of moral restraints if he hesitated to follow social responsibility enthusiasts when they urge radical relaxation of antitrust laws. See DAVID E. LILIENTHAL, BIG BUSINESS: A NEW ERA (1953).

be "vested in perpetuity in the Board of Directors," who would elect to their number "representatives" of investors, management, and the "plant community."[61] Drucker regards this as merely legalizing the disfranchisement already existing in fact. Criticizing this position, Lloyd K. Garrison expressed belief that[62]

> upon close examination it will be found that even in the case of the great corporations whose securities are widely distributed and largely voted by management proxies, effective control over many basic policy decisions is lodged in some stockholder group—perhaps in a very small minority, but in an effective one; . . .

Drucker brushes aside or disapproves not only the influence of particular stockholders, but also the general influence arising from the possibility of organized opposition. But after recent examples of proxy warfare, it would be rash to assert that these possibilities exert no wholesome stimulus or restraint upon management. When poor management is reflected in reduced earnings, the resulting decline in stock prices may create attractive opportunities to accumulate shares in a bid for control. To be sure, the stock market is not an ideal mechanism for the discipline of management. But, whatever may be the dangers from corporation "raiders," it is at least doubtful that management responsibility would be improved by making it impossible to acquire working control through purchases of stock.[63]

The vitality of the "social responsibility" theory is not to be measured by the limited enthusiasm which these typical proposals have engendered. The theory is important as a perennial insistence that there just *must* be some new way of disciplining corporate profit-seeking. Expressing his disappointment with Bowen's report, the Rev. F. Ernest Johnson asked almost wearily "Is it not possible to devise instruments of a more authentic corporate responsibility?"[64] But the prospect of a break-through on this front is not encouraging, for what is demanded is a contrivance which would operate neither through individual responsibility and competitive markets nor through political controls.

The new philosophy has thus far succeeded in producing only an unresolved discontent with existing corporation law. It has obscured the values served by the older philosophies and the fact that these philosophies also can lay claim to the "social responsibility" label. Perhaps corporation law critics should keep straining to catch Professor Berle's vision of "The Modern Corporation and the City of God."[65] But in the meantime, we need not be defensive about the statutes of North Carolina and Texas—or even those of Illinois and Delaware. None of them, to be sure, is a model ordinance for the City of God. But the corporate organizations they make possible are institutions not inappropriate for economic activity in the Earthly City.

[61] PETER F. DRUCKER, THE NEW SOCIETY 340, 342 (1950). See also PETER F. DRUCKER, CONCEPT OF THE CORPORATION (1946).

[62] NEW YORK UNIVERSITY SCHOOL OF LAW, SOCIAL MEANING OF LEGAL CONCEPTS NO. 3, THE POWERS AND DUTIES OF CORPORATE MANAGEMENT 259 (1950).

[63] See Director, *The Modern Corporation and the Control of Property*, in UNIVERSITY OF CHICAGO LAW SCHOOL CONFERENCE ON CORPORATION LAW AND FINANCE 17 (1951).

[64] Commentary, pt. 2, HOWARD R. BOWEN, SOCIAL RESPONSIBILITIES OF THE BUSINESSMAN 254 (1953). *Cf.* STEPHEN F. BAYNE, THE OPTIONAL GOD 48-51 (1953).

[65] This is the title of the final chapter of BERLE, *op. cit. supra* note 4.

THE ROLE OF THE STATES IN CORPORATE REGULATION AND INVESTOR PROTECTION

RICHARD W. JENNINGS*

INTRODUCTION

The purpose of this paper is to explore some of the current issues and trends in state corporation and securities legislation. There is a wide difference of opinion as to whether state incorporation statutes should be primarily enabling acts, with a minimum of regulation, or whether they should include additional protective provisions designed to establish more adequate safeguards for shareholders and creditors. A similar controversy exists in the field of state securities regulation, where varying approaches range from little or no regulation to a maximum of it.

The competition among the states for corporate charters has been a dominant factor in bringing about lax corporation statutes, although from time to time, individual states have attempted to resist such pressures. More recently, the Model Business Corporation Act,[1] sponsored and drafted by the American Bar Association Committee on Corporate Laws, has exerted a considerable influence in several American jurisdictions which have undertaken a revision of their corporation statutes.[2]

In the field of state securities regulation, the Harvard Law School Study of State Securities Regulation, under the direction of Professor Louis Loss and Edward Cowett, has culminated in the "promulgation" of a new Uniform State Securities Act which has as its purpose the promotion of uniformity in this area of the law.[3] This new Uniform Act has received the approval of the National Conference of Commissioners on Uniform State Laws[4] and the endorsement of the House of Dele-

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[1] COMMITTEE ON CORPORATE LAWS, AMERICAN BAR ASSOCIATION, MODEL BUSINESS CORPORATION ACT (1953); *id.*, REVISIONS AND OPTIONAL SECTIONS (1955); *id.*, ADDENDUM OF REVISIONS, ALTERNATIVE PROVISIONS AND OPTIONAL SECTIONS (1957). These will hereafter be referred to as the 1953, 1955, and 1957 revisions.

[2] Included are Wisconsin (1951), Oregon (1953), Texas (1955), Virginia (1956), North Dakota (1957), Alaska (1957), and Colorado (1958). The Model Act was also used by Congress in enacting a corporation law for the District of Columbia. See Campbell, *The Model Business Corporation Act,* Business Lawyer, July 1956, pp. 98, 106-07.

[3] LOUIS LOSS AND EDWARD COWETT, A PROPOSED UNIFORM SECURITIES ACT—FINAL DRAFT AND COMMENTARY (1956). This temporary edition has since been superseded by a treatise on the state blue-sky laws which also includes the new Uniform Securities Act with Official Comments and Draftsmen's Commentary. LOUIS LOSS AND EDWARD COWETT, BLUE SKY LAW (1958). The Uniform Act also appears in 9C U.L.A. 84 (1957).

[4] NAT'L CONFERENCE OF COMM'RS ON UNIFORM STATE LAWS, HANDBOOK 134-35 (1956).

gates and the Board of Governors of the American Bar Association.[5] It has been less warmly received by the National Association of Securities Administrators (since renamed North American Securities Administrators), which, after having given a guarded approval of the Act "insofar as may be practicable to promote uniformity in legislation," has made clear that this gesture "was not intended to and did not approve or recommend the Uniform Act for adoption in any state."[6]

It seems particularly appropriate in this symposium to pinpoint some of the difficulties in formulating an effective legislative program at the state level; to take inventory of our past experience; and to evaluate these latest efforts to provide guidance for the formulation of state legislation. In the last connection, special attention will be given a determination of the extent to which the new proposals will weaken or strengthen corporation legislation in our federal system.

I

CORPORATE CONTROL AND THE FEDERAL SYSTEM

A. The Problem of Charter-Mongering: Corporate Homes Away from Home[7]

The regulation of corporate enterprise in the United States so as to afford adequate protection for investors poses many complexities. Despite the tremendous growth in the number and size of corporation, the interstate character of the economy, and existing federal securities legislation, the states play a crucial part in the development of effective techniques for the prevention of abuse of power by management and majority shareholders and for the safeguarding of rights of minority shareholders and other investors.

The power to incorporate is conferred by the states under general incorporation laws. These statutes prescribe the corporate structure and the relationships between the management and the shareholders, between the majority and the minority shareholders, and between classes of shareholders. The extent to which the internal affairs of corporations are regulated varies markedly from state to state. The incorporation statutes of the more "liberal" states are essentially enabling acts, which contain many loopholes for an irresponsible management and a minimum of protective provisions in the interest of shareholders. Their general *laissez-faire* character is, in part, a product of our federal system, which permits the free choice of a state of incorporation, regardless of where the business is to be conducted.[8]

[5] 81 A.B.A. Rep. 145 (1956).

[6] NAT'L ASS'N OF SECURITIES ADM'RS, PROCEEDINGS 112 (1956); N. AM. SECURITIES ADM'RS, PROCEEDINGS 64-66 (1957).

[7] The phrase is suggested by Marias, *Liechtenstein, A Corporate Home Away from Home*, 12 BUSINESS LAWYER 405 (1957).

[8] Compare the Canadian system. The British North America Act, 1867, 30 & 31 VICT. c. 3, § 92, delegates to the provinces exclusive power to incorporate companies with "provincial objects." The residual authority to incorporate all other companies rests with the dominion government. Dominion companies have a federal right to carry on business in every province. Although a province may require such companies to register with its government, compliance cannot be made a condition precedent to doing business within its territory. They may also enforce general regulatory laws against a dominion company, including tax and securities laws. A province cannot confer upon local corporations power to do business elsewhere, but it can confer upon its companies the capacity to accept extraprovincial

These "liberal" state statutes date from the latter part of the last century, when certain states began to revamp their corporation statutes so as to give the widest latitude to corporate promoters and managers, with a view to inducing out-of-state businesses to incorporate in the state and escape restrictive legislation at the business home.[9] Vast numbers of corporations engaged in interstate business took shelter in these corporate havens, even where no business was to be conducted in the state of incorporation. Moreover, "pseudo foreign corporations" were formed by incorporating a purely intrastate business in a charter-mongering state solely for the purpose of becoming liberated from effective regulation in the home state.[10] In the words of Mr. Justice Brandeis:[11]

> [L]ocal restriction seemed worse than futile. Lesser States, eager for revenue derived from the traffic in charters, had removed safeguards from their own incorporation laws. Companies were early formed to provide charters for corporations in states where the cost was lowest and the laws least restrictive. The States joined in advertising their wares. The race was not one of diligence but of laxity . . . and the great industrial States yielded in order not to lose wholly the prospect of the revenue and the control incident to domestic incorporation.

Where individual states have sought to resist these pressures, the "pseudo-foreign corporation" has become the problem-child of all efforts at effective regulation.

A partial answer to the problem of charter-mongering might have been found in the enactment of a federal incorporation statute applicable to some or all corporations engaged in interstate commerce, possibly with a limitation based upon the amount

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powers. Bonanza Creek Gold Mining Company, Ltd. v. Rex [1916] 1 A.C. 566. See generally CORNELIUS A. MASTEN AND WILLIAM K. FRASER, COMPANY LAW OF CANADA 24-28 (4th ed. 1941).

[9] This movement, although it has an earlier history, received an added impetus with the New Jersey amendments of 1888, which generally authorized corporate holding companies. N.J. Laws 1888, c. 269, at 385. That same state enacted, in 1896, the first of the "liberal" general incorporation statutes, eliminating any restrictions on duration of existence, contributed capital, or types of enterprises. The Delaware incorporation statute of 1899 was modeled after the New Jersey original, but it emerged in many respects with even more advantages for management. Charter-mongering statutes were later enacted by Maine, Maryland, Nevada, and South Dakota, in some cases as defensive measures to retain corporate business rather than from conviction. See Compton, *Early History of Stock Ownership by Corporations*, 9 GEO. WASH. L. REV. 125 (1940); Wright and Baughman, *Past and Present Trends in Corporation Law: Is Florida in Step?*, 2 MIAMI L.Q. 69, 86 (1947); JAMES C. BONBRIGHT AND GARDINER C. MEANS, THE HOLDING COMPANY 55-64 (1932); Louis K. Liggett Co. v. Lee, 288 U.S. 517, 557-64 (1933). For current discussion, see Bedingfield, *They Want to Get Away from It All*, N.Y. Times, April 21, 1957, § 3, p. 1.

[10] See Latty, *Pseudo-Foreign Corporations*, 65 YALE L.J. 137 (1955). In the international field, inducements to migrate as a means of escape from restrictive tax, labor, or other legislation or to conceal ownership are also offered. In New York and Zürich, organizations exist with facilities to activate a Liberian corporation within forty-eight hours; if greater speed is needed, these correspondents have available, for a fee, corporate shells, already processed in Liberia, and ready for immediate delivery. See Rudick, *Foreign Domiciles for Corporations—Advantages Offered by the Republic of Liberia*, 12 BUSINESS LAWYER 257, 260, 261 (1957); Marias, *supra* note 7.

For collateral problems, see Surrey, *Current Issues in Taxation of Corporate Foreign Investment*, 56 COLUM. L. REV. 815, 827 (1956); Baker and Meek, *Tax Problems of Doing Business Abroad: Some Practical Considerations*, 1957 WIS. L. REV. 75 *passim;* Kronstein, *The Nationality of International Enterprises*, 52 COLUM. L. REV. 983, 986 (1952); Domke, *"Piercing the Corporate Veil" in the Law of Economic Warfare*, 1955 WIS. L. REV. 77.

[11] Louis K. Liggett Co. v. Lee, 288 U.S. 517, 557 (1933).

of gross assets.[12] Not only would this solution continue our present dual system of regulation, but, unless a federal incorporation statute were made compulsory, the net effect might simply be to add Washington, D. C., as one more place of incorporation.[13] Furthermore, except in a time of business crisis, when the currents of reform are running strong, the probabilities are that a federal incorporation statute might actually be more lax than that of some of the states more committed to regulation. In any event, the drive for federal incorporation, which has evoked interest from time to time, appears to have been blunted by the enactment of the federal securities legislation administered by the Securities and Exchange Commission.[14]

Quite apart from historical factors, the philosophical justification for the *laissez faire* approach of state corporation statutes may be thought to rest in an abiding faith "in the right of men to choose their own associates, make their own arrangements, govern themselves and thus grow in responsibility without much in the way of either hindrance or help from the state."[15] Although this theory has a certain tantalizing attraction, it overlooks the increasingly impersonal nature of the relationship between corporate management and the shareholders which results from the wide diffusion of shares.[16] It mistakenly assumes that lax state statutes supplemented by common law provide adequate investor protection. Furthermore, it cannot be regarded as the uniform or even the prevailing view in every state of the United States.

B. Attempts at Improvement of State Corporation Statutes

1. *The period from 1928-40*

A shift in philosophy began to be discernible in the movement to overhaul and modernize corporation statutes which began in the late 1920's. The Commissioners on Uniform State Laws, after many years of study, recommended the Uniform Business Corporation Act in 1928.[17] In many ways, the timing was unfortunate, as the weaknesses underlying the then existing system of corporate regulation were not fully perceived. For these and other reasons, this search for uniformity ended in failure. Although the Uniform Act was adopted by the states of Louisiana (1928), Idaho (1929), and Washington (1933), with various modifications, it had

[12] See Berlack, *Federal Incorporation and Securities Regulation*, 49 HARV. L. REV. 396, 404 *passim* (1936). And see Reuschlein, *Federalization—Design for Corporate Reform in a National Economy*, 91 U. PA. L. REV. 91 (1942); HAROLD G. REUSCHLEIN, THE SCHOOLS OF CORPORATE REFORM (1950); E. G. Jennings, *Federal Incorporation or Licensing of Interstate Corporate Business*, 23 MINN. L. REV. 710 (1939). For an account of this movement, see LOUIS LOSS, SECURITIES REGULATION 58-62 (1951).

[13] See Berlack, *supra* note 12, at 404.

[14] See LOUIS LOSS, SECURITIES REGULATION 61 (1951).

[15] The words are those of Judge Wyzanski expressing his view of the judicial policy of the Supreme Judicial Court of Massachusetts relating to shareholder derivative suits. Pomerantz v. Clark, 101 F. Supp. 341, 346 (D. Mass. 1951). *But see* Dodd, *Amendment of Corporate Articles Under the New Ohio General Corporation Act*, 4 U. CIN. L. REV. 129-32 (1930).

[16] See ADOLPH A. BERLE, JR. AND GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932); THE DISTRIBUTION OF OWNERSHIP IN THE 200 LARGEST NON-FINANCIAL CORPORATIONS (TNEC Monograph No. 29, 1940).

[17] 9 U.L.A. 115 (1957).

much less influence upon the revision of the Ohio statute (1927-29).[18] Between 1928 and 1933, the following important commercial states made great progress in revising their statutes, using the Uniform Act as source material, but not as a barrier to careful study and drafting in the light of changing conditions: California (1929-33), Michigan (1931), Illinois (1933), Minnesota (1933), and Pennsylvania (1933).[19] In some cases, the revisions were prepared by committees appointed by the state legislatures or bar associations, assisted by corporation law specialists drawn from the law schools. Very useful reports were sometimes prepared explaining the sources and objectives sought to be accomplished.[20] A number of valuable articles were written examining the many policy questions surrounding the drafting of a well-balanced corporation statute.[21] By 1939, the Uniform Business Corporation Act had been withdrawn as a "Uniform Act" and had been designated as a "Model Act" for the stated reason that its subject was not one "upon which uniformity between the states is necessary or desirable."[22]

2. *Developments since World War II*

a. *The ABA Model Act.* This movement for modernization and improvement of the corporation statutes, interrupted during the war years, has been revived with some curious results. In about 1940, the Committee on Business Corporations of the Section of Corporation, Banking, and Mercantile Law of the American Bar Association "was requested to prepare an appropriate form of Federal Corporation Act for use in case there should ever be a serious demand for such a statute."[23] When this project was completed, the Committee was requested to prepare a model act for state use.

The initial draft of the American Bar Association's Model Business Corporation Act was published in 1946.[24] The actual drafting was done by two or three members of the Committee who were active in corporate practice in Chicago.[25] This draft was largely based upon the Illinois Business Corporation Act, although the Commit-

[18] *Ibid.* See generally, E. MERRICK DODD AND RALPH J. BAKER, CASES AND MATERIALS ON CORPORATIONS 20 (2d ed. 1951); HENRY W. BALLANTINE, CORPORATIONS § 11 (rev. ed. 1946); Davies, *Reflections of the Amateur Draftsman of the Ohio General Corporation Act,* 12 WIS. L. REV. 487, 488-90 (1937).

[19] See E. MERRICK DODD AND RALPH J. BAKER, CASES AND MATERIALS ON CORPORATIONS 20 (2d ed. 1951); BALLANTINE, *op. cit. supra* note 18, at 45.

[20] See, *e.g.*, THE ILLINOIS BUSINESS CORPORATION ACT ANNOTATED WITH FORMS (2d ed. 1947), prepared and published by the Corporation Law Committee of the Chicago Bar Association. See also E. MERRICK DODD AND RALPH J. BAKER, CASES AND MATERIALS ON CORPORATIONS 20 (2d ed. 1951).

[21] *E.g.*, California: Ballantine, *Plans for a Modernized Incorporation Law,* 16 CALIF. L. REV. 425 (1928); Ballantine, *Changes in the California Corporation Laws,* 17 *id.* at 529 (1929); Ballantine, *Questions of Policy in Drafting a Modern Corporation Law,* 19 *id.* at 465 (1931). Ohio: Davies, *supra* note 18; Davies, *Shares Under the Ohio General Corporation Act,* 4 U. CIN. L. REV. 1 (1930); Dodd, *Amendment of Corporate Articles Under the New Ohio General Corporation Act,* 4 U. CIN. L. REV. 129 (1930). Minnesota: Hoshour, *The Minnesota Business Corporation Act,* 17 MINN. L. REV. 689 (1933), 18 *id.* at 1 (1933); Solether and Jennings, *The Minnesota Business Corporation Act,* 12 WIS. L. REV. 419 (1937).

[22] 9 U.L.A. 115 (1957).

[23] Garrett, *History, Purpose and Summary of the Model Business Corporation Act,* Business Lawyer, Nov. 1950, p. 1.

[24] *Ibid.*

[25] *Ibid.*

tee did not immediately reveal the parentage.[26] Revisions of the 1946 draft were made in 1950, 1953, 1955, and 1957.[27]

In an article criticizing the Model Act (as of 1953) as "an invitation to irresponsibility," a member of the Chicago bar has traced its evolution from revision to revision and has pointed out "the trend of the successive drafts toward liberality and protection of management and toward relaxation of safeguards to stockholders, creditors and the public."[28] Other writers have seriously questioned the basic philosophy of the Model Act.[29] The meager reports and explanations of the Committee fail to disclose this process of erosion or to indicate why it was thought necessary or desirable.[30] More recently, a member of the Committee stated his belief as to the objectives sought to be attained in the Model Act:[31]

(a) a modern act; (b) a complete act; (c) a flexible act; and (d) a relatively simple act. If the model act does not meet these characteristics it does not accomplish its purpose of serving as a base for the revision of corporation statutes. It has been described as an enabling act, and it is primarily that. It does not purport to be a policing act. *The policing must be left to blue-sky statutes and other statutes of that character, and to case law defining fraud and delineating the obligations of majorities to minorities.*

One would have supposed, on the contrary, that the purpose of promulgating a model corporation act should be to propose changes which would correct existing defects and abuses in our corporation statutes and in the practices of corporation finance.

b. *Loopholes and deficiencies in the ABA Model Act.* The extent to which the Model Act fails to close loopholes which permit management abuse and to enact provisions for the protection of shareholders and investors may be noted by comparing some of its features with those of the California Corporations Code, one of the most advanced of the state statutes.[32] Although the two statutes are similar in

[26] The first such disclosure I have been able to find is by Garrett, *Model Business Corporation Act*, 4 BAYLOR L. REV. 412, 424 (1952). And see Campbell, *supra* note 2, at 100. The Illinois statute had been rather thoroughly dissected at the time of its promulgation. See Ballantine, *A Critical Survey of the Illinois Business Corporation Act*, 1 U. CHI. L. REV. 357 (1934).

[27] See note 1 *supra*. The 1950 draft was published in Garrett, *History, Purpose and Summary of the Model Business Corporation Act*, Business Lawyer, Nov. 1950, p. 1.

[28] Harris, *The Model Business Corporation Act—Invitation to Irresponsibility?*, 50 NW. U. L. REV. 1, 2 (1955).

[29] Wright, *Current Developments in Statutory Corporation Law*, 7 MIAMI L.Q. 1, 6-13 (1952); Emerson, *Vital Weaknesses in the New Virginia Stock Corporation Law and the Model Act*, 42 VA. L. REV. 489 (1956). *But see* Gibson, *The Virginia Corporation Law of 1956*, *id.* at 445, 449.

[30] Compare the prefaces to the 1950 and 1953 revisions. COMMITTEE ON CORPORATE LAWS, AMERICAN BAR ASSOCIATION, MODEL BUSINESS CORPORATION ACT iv-xii (1953); Harris, *supra* note 28, at 3-5 *passim*.

[31] Campbell, *supra* note 2, at 99-100. (Emphasis added.)

[32] The California General Corporation Law of 1931 was the product of a very energetic and public spirited state bar committee made up of practicing lawyers, assisted by Professor Henry W. Ballantine, of the University of California School of Law, Berkeley. See Ballantine, *A Critical Survey of the Illinois Business Corporation Act*, 1 U. CHI. L. REV. 357 (1934); HENRY W. BALLANTINE, CORPORATIONS 45 (rev. ed. 1946). The statute was further revised in 1937. See Sterling, *Amendments to California Corporation Laws, 1937: Readjusting Stock Structure*, 26 CALIF. L. REV. 76 (1937). Under the supervision of the California Code Commission, in 1947, the legislation was recast in form, without a change in substance, and codified. See Buhler, *1947 California Corporations Code and Other Corporations Legislation*, 35 *id.* at 423 (1947).

many respects, they rest upon essentially different outlooks. The California draftsmen apparently aimed at making their statute[33]

> . . . liberal enough to facilitate business transactions without undue formalities of checks and balances, of votes and consents of shareholders, and applications to courts, and at the same time not so lax that the management or the majority may manipulate the machinery to the prejudice of creditors or investors or the oppression of minority shareholders.

In a nutshell, what the Model Act lacks and the California Corporations Code seeks to embody is an appreciation of the important role of shareholders and creditors in any prosperous business community. Although a legislature should not attempt to forge a conduit within which business transactions must be channeled, "freedom of contract" should yield to the extent necessary for statutory protection of the legitimate interests of the suppliers of corporate capital. A catalogue of some of the provisions of the Model Act and the California Corporations Code will serve to point up this difference in approach.

(1) *Loans to directors.* The Model Act prohibits any loans by the "corporation" to its officers or directors, but it may "otherwise assist its employees, officers and directors."[34] Not only does the statute fail to preclude loans to such persons by subsidiary or holding companies (a possible source of evasion), but it leaves open the possible contention that "otherwise assist" would permit the corporation to guarantee obligations, although direct loans were prohibited. In contrast, the California statute forbids loans of money or property by a corporation to a director or officer of the corporation or to the directors or officers of any of its subsidiary or holding corporations, or any guarantee of his obligations by such corporations, directly or indirectly.[35] The California statute is a much more tightly-drafted provision, which leaves no doubt that the intention of the framers is to preclude use of the corporate mechanism by the officer or director as a tool for his own financial manipulations.

The Model Act forbids a corporation to make loans secured by its shares, but, again, leaves open a loophole for possible evasion by the use of subsidiaries or holding corporations. In contrast, the California statute prohibits a corporation from making loans on the security of its shares or the shares of any holding corporation or subsidiary, unless the holders of two-thirds of all classes of shares, excluding the shares held by any benefited director, officer, or shareholder, consent, regardless of limitations on voting rights.[36] It is to be noted that the California statute allows some flexibility by permitting such loans where an independent two-thirds majority of all shares consent to the transaction. This provision may be particularly useful in the case of a closely-held corporation.

Finally, the contrast between the two statutes appears from the facts of an actual

[33] Ballantine, *Questions of Policy in Drafting a Modern Corporation Law,* 19 *id.* at 465 (1931).

[34] MODEL BUSINESS CORPORATION ACT §§ 42, 4(f), 43(d).

[35] CAL. CORP. CODE § 823. See the 1957 amendment, Cal. Stat. 1957, c. 278. For the definitions of "holding corporation" and "subsidiary corporation," see CAL. CORP. CODE § 118.

[36] *Id.* § 823. *Cf.* N.C. GEN. STAT. § 55-22 (Supp. 1955).

transaction. A corporation wishes to finance the purchase of its shares by an officer-director. The corporation, instead of making a direct loan, agrees to deposit funds with a bank, in escrow, with instructions to purchase the shares in the officer's name on the open market, the certificate of stock being held in escrow, pending payment of the purchase price in installments, with interest. It seems clear that this transaction would violate the California statute, although under the Model Act, the corporation might be merely "assisting" its officer-director.[37]

(2) *Indemnification of directors.* The Model Act permits the corporation to indemnify any director or officer for expenses actually and necessarily incurred by him in connection with the defense of any action except where he is *adjudged* liable for negligence or misconduct in the performance of duty. This provision is lifted from section 122(10) of the Delaware Corporation Law, although that type of statutory solution had previously been subjected to very severe and justifiable criticism.[38] Under this language, the director or officer would always be entitled to reimbursement for amounts paid to compromise or settle the controversy and for litigation expenses (including attorneys' fees), even though the settlement was effected without an adjudication of the issue of negligence or misconduct, without court approval of the settlement after notice to shareholders, and without a judicial determination that the defendant's conduct equitably merited reimbursement and that the amounts paid were reasonable.[39] Moreover, the section is not exclusive, so that the avenue is left open for a bylaw allowing indemnity, even though the director or officer is adjudged to be liable for negligence or misconduct. In California, on the contrary, instead of encouraging or permitting undue "freedom of contract" to vary the legislative rule, the statute is made the exclusive source of the right to indemnification. In order to be entitled to reimbursement for litigation expenses, a director or officer must be "successful" in whole or in part, or the proceeding must have been settled with approval of the court. In addition, the court must find that his conduct "fairly and equitably merits such indemnity."[40]

By a 1957 amendment to the California Corporations Code, the corporation may also reimburse a director, officer, or employee for expenses or for any judgment or fine rendered against him in any action brought by a third person, if the board of

[37] *Cf.* Billings v. Trask, 30 Hun 314 (N.Y. Sup. Ct., Gen. T. 1883); Rubenstein v. Kasprzak, 96 N.J. Eq. 406, 124 Atl. 362 (1924).

[38] Ballantine, *California's 1943 Statute as to Directors' Litigation Expenses: An Exclusive Remedy for Indemnification of Directors, Officers and Employees*, 31 CALIF. L. REV. 515, 516 *passim* (1943). *Cf.* MODEL BUSINESS CORPORATION ACT § 4(o).

Mr. Charles W. Steadman, a member of the ABA drafting committee, has explained the choice of the Delaware prototype: "It was our feeling that its simplicity was to its advantage. It is an uncomplicated statute. It has further the advantage of flexibility of leaving to each corporation and to the shareholders of the corporation the decision as to whether or not there should be indemnification." *What's New in Corporation Laws—Indemnification of Directors*, Business Lawyer, Jan. 1953, pp. 1, 9. *Cf.* DEL. CODE ANN. tit. 8, § 122(10) (1953).

[39] See Neuberger v. Barrett, 180 Misc. 222, 39 N.Y.S2d 575 (Sup. Ct. 1942); Tichner v. Andrews, 193 Misc. 1050, 85 N.Y.S.2d 760 (Sup. Ct. 1949); Dornan v. Humphrey, 278 App. Div. 1010, 106 N.Y.S.2d 142 (4th Dep't 1951); Diamond v. Diamond, 307 N.Y. 263, 120 N.E.2d 819 (1954).

[40] CAL. CORP. CODE § 830.

directors determines that he was acting in good faith within what he reasonably believed to be the scope of his employment or authority and for a purpose which he reasonably believed to be in the best interests of the corporation or its shareholders. This proviso, however, does not apply to derivative suits.[41]

The California statute, thus, proceeds upon the theory that the right of indemnification should be subject to rather strict statutory regulation to prevent abuse and that directors and officers should not be permitted to thwart that policy by resort to management-sponsored article or bylaw provisions.

(3) *Interested directors' contracts.* According to the Model Act, executive compensation may be fixed by the board of directors, unless otherwise provided in the articles of incorporation. Section 4(p) authorizes the corporation to establish stock option plans and stock bonus plans for directors, officers, and employees. The 1955 revision contains an optional section with respect to stock options and rights; if such rights or options are to be issued to the directors, officers, or employees of the corporation or of any subsidiary, the terms of the transaction must be approved by shareholders representing a majority of the voting power.[42] But apparently this requirement may be dispensed with and is subject to inconsistent provisions in the articles.

The Model Act attempts no statutory solution of the broad problem of interested directors' contracts. It is customary in the United States to insert in the articles of incorporation or the bylaws clauses permitting interested directors to contract with the corporation and allowing contracts between corporations with common directors. Many of these directors' exculpatory clauses purport to give an unrestrained authorization for contracts with directors or corporations with common directors, despite fraud or unfairness or the lack of an independent quorum or vote.[43]

On the other hand, the California statute seeks to displace the confusing and sometimes contradictory common-law rules, as well as all immunizing and exculpatory clauses, with specific statutory regulation.[44] If a director or officer is financially interested in any corporate transactions, his presence at the meeting of the board of directors approving the transaction will not invalidate the transaction, provided his interest is known or disclosed and the transaction is approved *in good faith* either by a disinterested majority of the directors or by a majority of the shareholders entitled to vote, or provided the transaction is just and reasonable as to the corporation at the time it is so authorized, even though his vote was necessary for director approval.[45] Whether or not one agrees with the particular solution sug-

[41] Cal. Stat. 1957, c. 2261, § 3. *Cf.* Schwarz v. General Aniline & Film Corp., 305 N.Y. 395, 113 N.E.2d 533 (1953).

[42] MODEL BUSINESS CORPORATION ACT § 18A.

[43] See HENRY W. BALLANTINE, NORMAN D. LATTIN, AND RICHARD W. JENNINGS, CASES AND MATERIALS ON CORPORATIONS 300 (2d ed. 1953); Sterling v. Mayflower Hotel Corp., 33 Del. Ch. 293, 93 A.2d 107 (Sup. Ct. 1952).

[44] CAL. CORP. CODE § 820.

[45] Remillard Brick Co. v. Remillard-Dandini Co., 109 Cal. App. 2d 405, 241 P.2d 66 (1952); Comment, *Effect of Statutes on Contracts Between Corporations With Common Directors*, 51 MICH. L. REV. 705 (1953). *Cf.* N.C. GEN. STAT. § 55-30 (Supp. 1955), which follows the California pattern,

gested by the California statute, it seems advisable to reduce the problem to statutory regulation, thereby foreclosing immunizing or exculpatory clauses, which are usually prepared by or for management.

(4) *Shareholder control of bylaw amendments.* The Model Act places the power to adopt the original bylaws in the board of directors and also the power to amend or repeal them, unless the articles reserve such power to the shareholders.[46] In California, the shareholders may adopt, amend, or repeal the bylaws, with the board of directors also having such power, subject to being overridden by shareholders possessing a majority of the voting power.[47] Moreover, articles or a bylaw adopted by the shareholders may limit or deprive the directors of the authority to make or repeal bylaws. Although the articles or bylaws may provide for a super-majority vote of shares to alter the bylaws, the shareholders cannot be completely deprived of their amendatory power.

California does not make the power of shareholders to change bylaws dependent upon the terms of the original articles. The Model Act allows an undue "freedom of contract," for it is common knowledge that the articles are generally prepared by the promoters' or managers' attorneys with a view to giving them as free a rein as possible. To the extent that the Model Act makes it more difficult for shareholders to make changes in the bylaws, it encourages a dictatorship of directors between annual elections.

(5) *Shareholder representation and voting rights.* The Model Act, like the California statute, contains a mandatory provision for cumulative voting for directors.[48] At the same time, however, that Act allows this policy to be frustrated by permitting the classification of directors and the staggering of their terms of office over as much as a three-year period,[49] a practice expressly prohibited in California.[50] Furthermore, in California, except where the articles provide for a maximum and minimum number of directors (which cannot be less than five), only the shareholders can amend the bylaws or articles to change the authorized number of directors.[51] But even where the directors are authorized to adopt a bylaw fixing the exact number of directors, this may be superseded by shareholder action. If the bylaws are amended to reduce the authorized number of directors below five, the votes of shareholders holding more than eighty per cent of the voting power are necessary.[52] This provision forestalls any scheme to minimize the effectiveness of cumulative voting by reducing the number of directors below five and, thus, guarantees representation on the board of directors to any shareholder or group having at least twenty per cent of the voting power. In contrast, under the Model Act, the authorized number of

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except that shareholder approval must be given by a majority of the voting power, other than the shares owned or controlled by the adversely-interested directors.

[46] MODEL BUSINESS CORPORATION ACT § 25.

[47] CAL. CORP. CODE § 500.

[48] MODEL BUSINESS CORPORATION ACT § 31.

[49] *Id.* § 35. The board must consist of nine or more members for this section to become applicable.

[50] CAL. CORP. CODE § 805.

[51] *Id.* § 500.

[52] *Id.* § 501(d).

directors may be changed by amendment of the bylaws, and, as we have seen, the articles may vest the power to amend in the board of directors exclusively.[53] Thus, another device for crippling cumulative voting is countenanced by the Model Act.

(6) *Removal of directors.* It has been generally held, in the absence of statute or a provision in the articles or bylaws, that shareholders may not remove a director from office before the expiration of his term, except for cause.[54] The articles of incorporation or bylaws sometimes provide that a majority of the shareholders may remove a director, with or without cause, before the expiration of his term of office.[55] In the absence of such a provision or statutory authority, even an overwhelming majority of the shareholders may find it difficult or impossible to remove an intrenched board of directors between annual elections.[56]

The authority of shareholders to remove directors at will is obviously an important safeguard and means of maintaining shareholder control over the board of directors. Accordingly, an increasing number of states (including California) have enacted statutes which authorize some specified majority of the shareholders to remove the directors at any time.[57] The California statute contains an important further safeguard designed to protect the cumulative voting rights of minority shareholders where less than the entire board of directors is removed.[58] On the other hand, it is surprising to find that the Model Act fails to confer a statutory power of removal upon the shareholders, although it seems to be contemplated that such a power might be conferred by the articles or bylaws.[59] It should be noted, however, that the 1955 revision of the Model Act does contain an "optional section" granting a statutory right of removal, which also preserves the rights of shareholders under voting systems calling for cumulative voting and the classification of boards of directors and the staggering of their terms of office.[60] Unless this optional section is enacted, however, the Model Act, as such, confers upon the shareholders no statutory right to remove the directors.

[53] MODEL BUSINESS CORPORATION ACT § 25.

[54] Campbell v. Loew's Inc., 134 A.2d 852 (Del. Ch. 1957); People *ex rel.* Manice v. Powell, 201 N.Y. 194, 94 N.E. 634 (1911); BALLANTINE, *op. cit. supra* note 18, at 434; 2 WILLIAM M. FLETCHER, PRIVATE CORPORATIONS § 352 (Perm. ed. rev. repl. 1954).

[55] See *In re* Rogers Imports, Inc., 202 Misc. 761, 116 N.Y.S.2d 106 (Sup. Ct. 1952), Note, 66 HARV. L. REV. 531 (1953).

[56] See HENRY W. BALLANTINE, NORMAN D. LATTIN, AND RICHARD W. JENNINGS, CASES AND MATERIALS ON CORPORATIONS 280 (2d ed. 1953).

[57] CAL. CORP. CODE § 810; MD. ANN. CODE art. 23, § 48 (1951); MINN. STAT. § 301.29 (1953); MONT. REV. CODES ANN. § 15-408 (1955); PA. STAT. tit. 15, § 2852-405 (1936); VA. CODE ANN. § 13-200 (Supp. 1956); WASH. REV. CODE § 23.36.040 (1951). In all, twelve states have enacted provisions for shareholder removal of directors, with or without cause. In addition, four others provide for such power, unless the charter or bylaws restrict or nullify it.

[58] CAL. CORP. CODE § 2235. Minnesota, Ohio, Pennsylvania, and Washington also have somewhat similar legislation. *Cf. In re* Rogers Imports, Inc., 202 Misc. 761, 116 N.Y.S.2d 106 (Sup. Ct. 1952); Campbell v. Loew's, Inc., 134 A.2d 852, 858 (Del. Ch. 1957).

[59] See *What's New in Corporation Laws—Removal of Diretcors,* Business Lawyer, Jan. 1953, pp. 27, 30 (statement by Charles W. Steadman, member of the drafting committee).

[60] MODEL BUSINESS CORPORATION ACT § 36A. The 1955 revision introduces alternative and optional provisions to certain sections of the 1953 revision. Optional subjects concern matters which may be included in a state statute, but which were intentionally omitted as not "essential."

(7) *Repurchase of shares.* The Model Act permits a corporation to purchase shares out of earned surplus or, if the articles permit or two-thirds of the voting power consent, out of capital surplus.[61] As the promoters of the corporation normally dictate the initial charter provisions, it would be a rare case where the corporate managers in a Model Act jurisdiction would not avail themselves of this "freedom of contract." Conferring such an unrestricted power upon the corporation to deal in its own shares sanctions abuses which are prejudicial to the rights of creditors or preferred shareholders or which may favor the inside or influential shareholders at the expense of the outside shareholders.[62] In contrast, the California statute allows, with some exceptions not of general application, purchase of common shares only out of earned surplus.[63] In a one-class situation, surplus arising from the reduction of stated capital may be used to purchase common shares under safeguards designed to prevent discrimination in favor of insiders.[64] In a two-class situation, paid-in surplus and reduction surplus are available only for the purchase or redemption of preferred shares subject to redemption, at not to exceed the redemption price.[65] Preferred shares not subject to redemption may be purchased only by the use of reduction surplus, upon reasonable and nondiscriminatory terms, at not more than the lowest liquidation price for the shares.[66]

(8) *Grant of immunity to foreign corporations.* Although the Model Act is primarily an incorporation statute, under section ninety-nine, jurisdictions enacting it are asked to sign away any right to regulate the internal affairs of foreign, or even pseudo-foreign corporations. That section, in part, provides:

> A foreign corporation shall not be denied a certificate of authority by reason of the fact that the laws of the state or country under which such corporation is organized governing its organization and internal affairs differ from the laws of this State, and nothing in this Act contained shall be construed to authorize this State to regulate the organization or the internal affairs of such corporation.

This escape hatch serves as an open invitation to corporate managers to incorporate away from home if they consider the Model Act to be too restrictive, as well as insures that foreign corporations, wherever organized, will be entirely free from local regulation in the crucial area of management-shareholder relationships. Because of the limitation on regulation "in this Act," however, it is believed that the adoption of section ninety-nine would not prevent the exercise of broad powers for the protection of investors under a state blue-sky law.

Not all of the provisions of the Model Act compare unfavorably with the Cali-

[61] *Id.* § 5.

[62] See Note, *Purchase by a Corporation of Its Own Preferred Shares With Dividends in Arrears,* 14 U. CHI. L. REV. 66 (1946); Note, *Stock Repurchase Abuses and the No Prejudice Rule,* 59 YALE L.J. 1177 (1950).

[63] CAL. CORP. CODE §§ 1706-08.

[64] *Id.* § 1906.

[65] *Ibid.*

[66] *Ibid.* For a superb analysis of the Model Act sections relating to dividends and other distributions to shareholders, see Hackney, *The Financial Provisions of the Model Business Corporation Act,* 70 HARV. L. REV. 1357 (1957).

fornia statute; many provisions of the two acts are quite similar. For example, both provide substantial class-voting protection for preferred shareholders who may be adversely affected by charter amendments.[67] Nevertheless, the foregoing comparison of the two acts on a substantial number of crucial matters, while by no means exhaustive, highlights the fact that the accent in the Model Act is upon simplicity and flexibility at the expense of fair and adequate protection of the shareholders against potential management abuse, whereas the California statute embodies many more regulatory provisions resulting in additional protection to shareholders and creditors. In short, the Model Act is misnamed. Far from being a "model," it is too simple, too flexible, and too full of loopholes and deficiencies in favor of management. It appears to be a product of either poor drafting or (what is more likely the case) too close attention to the wishes of corporate clients and too little concern for the public interest and the protection of investors.[68] We have a right to expect a higher standard of performance from a quasi-public committee. It is not too much to ask that the Committee be infused with new blood and that its position on a number of vital points be re-examined.

c. *The North Carolina Business Corporation Act of 1957—An Experiment in Corporate Regulation.* The North Carolina revision program has been described elsewhere.[69] This work was carried out under the supervision of the General Statutes Commission, an official state agency. The actual drafting was the work of corporation law specialists drawn from the law schools of the state.[70]

The draftsmen not only sought to prepare a "technically excellent enabling act," but also made a conscious effort to develop built-in safeguards for the protection of the outside shareholders.[71] A number of these innovations deserve careful study. There is, for example, a mandatory dividend provision designed to prevent "squeeze plays" on minority shareholders in closely-held corporations.[72] There are statutory restrictions upon the repurchase of shares, the aims of which are to prevent favoritism or discrimination among shareholders.[73] A "dominant shareholder" provision re-

[67] MODEL BUSINESS CORPORATION ACT § 55; CAL. CORP. CODE §§ 3634, 3635.

[68] *Cf.* Emerson, *supra* note 29, at 531-34. See Seward, *The Movement for Modernization for Our State Corporation Laws,* 186 COM. & FIN. CHRON. 14, 34, 35 (1957), for a frank explanation of the motivation behind the ABA Model Business Corporation Act. Law firms and corporations "interested in corporation law" are being tapped for some $182,000 to finance the preparation of an annotation of the Model Business Corporation Act and the Model Non-Profit Corporation Act.

[69] Latty, Powers, and Breckenridge, *The Proposed North Carolina Business Corporations Act,* 33 N.C.L. REV. 26 (1954); Powers, *Drafting a Corporation Code for North Carolina,* 10 ARK. L. REV. 37 (1955); Latty, *Uncertainties in Permissive Sources of Dividends Under Present G.S. 55-116,* 34 N.C. L. REV. 261 (1956); Latty, *The Close Corporation and the New North Carolina Business Corporation Act, id.* at 432.

[70] Professors E. R. Latty, Duke University School of Law; L. S. Powers, Wake Forest School of Law (now at University of Florida College of Law); and M. S. Breckenridge, University of North Carolina School of Law.

[71] Powers, *Drafting a Corporation Code for North Carolina,* 10 ARK. L. REV. 37, 39-41 (1955).

[72] N.C. GEN. STAT. § 55-50(i) (Supp. 1955); Powers, *Drafting a Corporation Code for North Carolina,* 10 ARK. L. REV. 37, 42 (1955). Moreover, special attention is given to the problems of the closely-held corporation. See Latty, *The Close Corporation, and the New North Carolina Business Corporation Act,* 34 N.C. L. REV. 432 (1956).

[73] N.C. GEN. STAT. § 55-52 (Supp. 1955).

stricts loans to controlling shareholders as well as to officers and directors.[74] Exculpatory and indemnification provisions in charters and bylaws have, in general, been banned in favor of direct statutory regulation.[75] Bylaw provisions authorizing bonuses to corporate officers measured by income or volume of business have a terminal effectiveness of five years, unless renewed by a majority shareholder vote.[76]

A number of provisions are specifically concerned with strengthening the position of preferred shareholders and protecting them against inequities. Conventional noncumulative preferred share contracts are prohibited; for the future, only the cumulative-if-earned variety will be allowed.[77] A helping legislative hand is extended when preferred shareholders are confronted with an unfair plan of recapitalization. Class voting on charter amendments, mergers, and consolidations is mandatory, even as to preferred shares which are otherwise nonvoting.[78] In the event of prejudicial changes in preferred shares, whether effected by direct charter amendment, merger, consolidation, or a "voluntary plan of recapitalization," an appraisal right is given to dissenters.[79]

The rights of appraisal by dissenting shareholders is enlarged in one other respect. Added to the usual provision for appraisal in mergers and consolidations is a special feature conferring an appraisal right to dissenters of the selling corporation where a business combination is effected by a sale of all assets in exchange substantially for shares of the purchasing corporation.[80]

Perhaps the most unique feature of the North Carolina legislation is the attempt to police a large number of potential abuses and inequities through direct legislation, rather than through the use of a strong state securities act.

One proposal, which was eliminated from the final statute, was a rather ingenious attempt to forestall circumvention of the statute by out-of-state incorporation, the "pseudo-foreign corporation" problem to which reference has previously been made.[81] The draftsmen, recognizing the possibility that corporations might flee to more hospitable shores, made certain of the shareholder protective provisions applicable to "pseudo-foreign corporations." This term included[82]

> . . . a foreign corporation which after the enactment of this chapter obtains for the first time a certification of authority to transact business in this State and which engages in no substantial business activity in the state or country of its incorporation, and which, by virtue of the place and character of its business and personnel, is more closely identified with the business life of this State than with any other state or country; but the term does not include a corporation formed under or by laws of the United States.

[74] *Id.* §§ 55-2(6), 55-22. *Cf.* CAL. CORP. CODE § 823, which overlooks this problem.

[75] N.C. GEN. STAT. §§ 55-20, 55-30 (Supp. 1955).

[76] *Id.* § 55-16(a)(3).

[77] *Id.* §§ 55-2(5), 55-40(c).

[78] *Id.* §§ 55-100, 55-101.

[79] *Id.* §§ 55-102, 55-113.

[80] *Id.* § 55-113.

[81] *Supra* note 10 and text to which cited. The General Statutes Commission submitted to the 1955 North Carolina General Assembly a proposed new Business Corporations Act. S. 49 (1955).

[82] *Id.* §§ 55-2(11), 55-2(12); see also *id.* §§ 55-19(c), 55-134, 55-135, 55-136.

Space does not permit an exploration of all of the various ramifications of this statute.[83] It must be noted, however, that the jurisdictional base is that of *doing business within the state* and *identification with the business life of the state,* rather than the issue or sale of shares within the state, or even ownership of shares by residents of the state. Thus, the proposal would apparently have been applicable where a Massachusetts corporation, all of whose shareholders were and continued to be residents of Massachusetts, transferred its operations from Massachusetts to North Carolina. Under such circumstances, the policy of imposing North Carolina standards in management-shareholder relationships is questionable. Nevertheless, at least an attempt was made to solve one of the most delicate questions in the area of interstate relations: How may a state protect its general incorporation statute from subversion through foreign incorporation? It is believed that any such policing should be accomplished through administration supervision under a state securities act. The second part of this paper will be concerned with this problem.

II

STATE SECURITIES ACTS AS INSTRUMENTS OF CORPORATE REGULATION

If a state desires a general incorporation statute with more regulatory provisions to safeguard investors along the lines of the California and North Carolina statutes, some means must be found to minimize and discourage circumvention of the statutes through out-of-state incorporation. We have seen how the draftsmen of the North Carolina statute attempted to meet this problem by a limited "domestication" of quasi-foreign corporations. Another method which has not been given the recognition which it deserves is that of using the state securities acts or "blue-sky" laws as instruments of corporate regulation. The chief interest of the state in these matters is that of protecting its shareholders against unfair and inequitable share structures loaded in favor of promoters and managers. The time to check these arrangements is when the corporation proposes to issue or sell securities. Even a lax corporation statute may be strengthened by a strong "blue-sky" law, and a more regulatory corporation statute can be buttressed by a fair but effective state securities statute. In this connection, it is important to consider the various types of blue-sky laws and their strengths and deficiencies as instruments for providing a greater measure of protection for shareholders against potential management abuses.

A. Types of Securities Acts

There is no general agreement as to classification of securities acts.[84] In order to highlight basic differences in approach and to point up the scope and limitations of

[83] The proposed statute was discussed in Latty, *Pseudo-Foreign Corporations,* 65 YALE L.J. 137 (1955).

[84] See Dalton, *The California Corporate Securities Act,* 18 CALIF. L. REV. 115, 116-28 (1929); Smith, *The Relation of Federal and State Securities Laws,* 4 LAW & CONTEMP. PROB. 241 (1937); Wright, *Correlation of State Blue Sky Laws and the Federal Securities Acts,* 26 CORNELL L.Q. 258 (1941); LOUIS LOSS, SECURITIES REGULATION 19-44 (1951); LOUIS LOSS AND EDWARD COWETT, BLUE SKY LAW 17-42, 283-84 (1958).

the various types, my preference is for a division into four classes or combinations of classes: (1) fraud prevention; (2) licensing of broker-dealers; (3) qualification of securities, restricted to fraud prevention by compelling "full disclosure"; and (4) qualification of securities, with the imposition of varying degrees of substantive regulation of the terms and conditions under which securities may be sold or issued.

1. *Fraud prevention*

The antifraud statutes, of which the Martin Act in New York may be regarded as the prototype, are only a step removed from the individualistic approach of the civil and criminal law.[85] The attorney-general of the state is authorized to prevent "fraudulent practices" in the purchase and sale of securities by resort to the techniques of investigation, injunction, and criminal prosecution.[86] Curiously enough, the Martin Act "goes no further than to say that a fraud or a violation of law which would operate as a fraud is a fraudulent practice."[87] The courts, however, have given content to the statute by reading it to embrace not only legal fraud, but also the omission or concealment of material facts which in fairness should be disclosed to the purchaser or seller of securities.[88] Its purpose has been stated as being not only to prevent fraud, but to "defeat all unsubstantial and visionary schemes . . . whereby the public is fraudulently exploited."[89]

This type of statute attempts no substantive regulation and is, in fact, an ineffective fraud-prevention weapon. Securities frauds frequently are not detected until it is too late to take preventive measures.[90] Even where discovered, a full investigation is usually necessary to determine whether there is sufficient evidence to warrant prosecution. Then, there are the inevitable delays in bringing the case to trial—with the possibility of appeal—not to mention the many legal hurdles to be surmounted in establishing all of the elements of fraud.

On the other hand, if securities may be offered or sold only after qualification under a registration or permit system, not only is there an opportunity for administrative review prior to sale, but the enforcement problems are reduced. Failure to qualify the securities is itself a violation. After apprehension of the violator, any fraud aspects of the case may be pursued and prosecuted if the evidence is forthcoming. Prompt action may also enhance the likelihood of restitution to victims.

[85] N.Y. GEN. BUS. LAW § 352 *et seq.*

[86] See generally, LOUIS LOSS, SECURITIES REGULATION 20-26 (1951).

[87] People v. Federated Radio Corporation, 244 N.Y. 33, 38, 154 N.E. 655, 657 (1926).

[88] *Id.* at 41, 154 N.E. at 658.

[89] *Id.* at 38, 154 N.E. at 657.

[90] See, *e.g.*, People v. Tellier, 155 N.Y.S.2d 245 (S. Ct. 1956). For the testimony of Attorney General Javits, of New York, before a House subcommittee as to the futility of coping with the uranium boom by a simple fraud statute, see *Hearings before the Subcommittee on Commerce and Finance of House Committee on Interstate and Foreign Commerce on H.R. 5701*, 84th Cong., 474-88 (1955-56). These hearings also contain a case history of the role played by Mr. Tellier as a banker-promoter of uranium companies. *Id.* at 561-95. *Cf.* People v. Otterman, 154 Cal. App. 2d 223, 316 P.2d 85 (1957).

2. *Broker-dealer registration*

The second type of regulation is that of licensing the professional sellers of securities.[91] Such statutes may require the registration of brokers and dealers and their agents,[92] as well as registration of the agents of original issuers of securities. Licensing of investment counsellors is a later development. Broker-dealer registration may be made an adjunct of fraud prevention—this has been done in New York.[93] It may also be used to buttress a system of securities qualification, as has been done in the federal securities legislation and under a number of state blue-sky laws. Secondary sales of securities are frequently controlled at the broker-dealer level, rather than at the stage of original issue.[94] But since these statutes are aimed at dealers in securities rather than issuers, they play only a subsidiary role as instruments of corporate regulation.

3. *Securities qualification stressing disclosure*

The third type is that of requiring securities to be registered or qualified, with a view to preventing fraud by compelling full disclosure in a prospectus to be furnished to the prospective purchaser prior to sale. The Securities Act of 1933, with some exceptions, requires that new issues of securities offered by use of the mails or other channels of intertstate commerce shall be registered with the Securities and Exchange Commission, and that a prospectus (filed as a part of the registration statement) shall be furnished to the purchaser prior to the sale or, in some cases, at the time of the delivery of the security after sale.[95] According to the Commission,[96] its

> . . . primary function is to require full and adequate disclosure of all material facts in connection with a public offering of securities so that investors may, on the basis of such disclosure, arrive at an informed judgment as to whether or not to purchase the securities offered.

Civil liabilities are imposed upon the issuer and certain other persons for misstatements or omissions contained in the registration statement and prospectus in favor of purchasers of registered securities.[97]

The disclosure statutes are based upon the theory that once the facts are made ac-

[91] See LOUIS LOSS, SECURITIES REGULATION 26-30 (1951).

[92] The loopholes in the federal and New York securities statutes have created enforcement difficulties. See *Hearings, supra* note 90, at 477-79.

[93] N.Y. GEN. BUS. LAW § 359-e. In New Jersey, regulation is retricted to a simple antifraud statute. N.J. REV. STAT. tit. 49 (1937).

[94] See *e.g.*, CAL. CORP. CODE § 25602. See text at note 154 *infra*. In California, this solution has been dictated in part by the decision in People v. Pace, 73 Cal. App. 548, 238 Pac. 1089 (1925), which found supposed constitutional restrictions against requiring a broker's license for sales by a bona fide individual of personally-owned securities of which he was neither issuer nor underwriter, where the sales were for his own account and he did not engage in the business of dealing in securities. See Dahlquist, *Regulation and Civil Liability under the Californa Corporate Securities Act: II*, 34 CALIF. L. REV. 344, 363 (1946); *IV, id.* at 695, 719 (1946).

[95] 48 STAT. 74 (1933), as amended, 15 U.S.C. §§ 77a-77aa (1952).

[96] In the Matter of Tucker Corporation, Securities Act Release No. 3236, 1947, p. 1.

[97] Securities Act of 1933, §§ 11, 12, and 15, 48 STAT. 82, 84, as amended, 15 U.S.C. §§ 77k, 77l, 77o (1952); LOUIS LOSS, SECURITIES REGULATION 982-1029 (1951).

cessible to a prospective investor, then if he "does not take the trouble to inform himself before risking his money, he has no one to blame but himself."[98] Despite the apparent simplicity of this approach, numerous problems arise in administration. First, under the Federal Securities Act, sales may be made in person or by telephone, without the seller being required to furnish the buyer with a prospectus in advance, as long as the prospectus accompanies or precedes any written confirmation of the sale or, in the absence of such confirmation, accompanies or precedes delivery of the security after the sale.[99] Many securities are, thus, sold under circumstances where, for all practical purposes, the investor is committed before he ever sees the prospectus. Under this loophole, full disclosure is illusory, since the sale can be made by oral representations, and the prospectus serves only to inform the investor as to what he has already purchased.[100] Moreover, even where the prospective purchaser does receive the prospectus, it is at least doubtful whether he will take the time and trouble to read it or whether any but the more sophisticated investors will understand this complicated document.[101] Nor can it be assumed that the information will trickle down to the average investor through security analysts and financial advisers, particularly in cases of promotional or highly speculative securities.[102] The most important safeguard is the very careful administrative review to which the Securities and Exchange Commission subjects registration statements and prospectuses.[103]

The Commission prescribes the contents of the registration statement and prospectus. In order to carry out the statutory policy, the Commission has interpreted the requirement of full disclosure in very broad terms.[104] It compels compliance with

[98] Address by Louis Loss, Mexico Stock Exchange, June 6, 1957, at 8.

[99] Securities Act of 1933, § 5, 48 STAT. 77, as amended, 15 U.S.C. § 77e (1952).

[100] Byron D. Woodside, Director of the SEC Division of Corporation Finance, has said: "I think the facts of life are such that the securities . . . in promotional ventures in the uranium field and mining field generally, oil and gas and, indeed, in some of the other types of promotional issues, are sold on the basis of oral representations which convince people they are going to realize a profit if they buy, and I would guess in the vast majority of the cases, whether the issues . . . were registered, or not, as a practical matter you would not be able to nail anybody under section 11 [of the Securities Act of 1933], because I do not think that is where the misrepresentation is likely to be found. It is in the conversation that occurs between the salesman and the purchaser, and the dealer and the purchaser." *Hearings, supra* note 90, at 81. See LOUIS LOSS, SECURITIES REGULATION 58-61 (Supp. 1955). The same opportunity, of course, exists for all issues.

[101] *Cf.* Cole, Morley, and Scott, *Corporate Financing in Great Britain*, 12 BUSINESS LAWYER 321, 370, 371 (1957); LOUIS LOSS, SECURITIES REGULATION 158-61, 165-66 (1951); Douglas, *Protecting the Investor*, 23 YALE REV. (n.s.) 521, 523 (1934).

[102] *Cf.* LOUIS LOSS, SECURITIES REGULATION 166 (1951).

[103] *Id.* at 166-78.

[104] See Charles A. Howard, 1 S.E.C. 6, 11 (1934) (a statement is false if it conveys a false impression); Commonwealth Bond Corp., 1 S.E.C. 13, 24 (1934) (prophecies known to be untrue when made are untrue statements of fact, since they misstate the mind of the prophet); National Educators Mutual Ass'n, Inc., 1 S.E.C. 208, 215 (1935) (even though all statements are literally correct, the Commission may challenge a registration statement and prospectus upon the broad basis that, taken as an entirety, the general effect is to create a false impression in the minds of prospective investors); Plymouth Consolidated Gold Mines, Ltd., 1 S.E.C. 139, 146 (1935) (where the effect of the share structure is to permit promoters to siphon off most of the cash contributed by investors, there must be an "adequate and succinct disclosure of the effects of these strange and curious proceedings to the investor"); Haddam Distillers Corp., 1 S.E.C. 37, 47 (1934) (trusteeship of other people's money demands "some warrant

its standards by advising the registrant of shortcomings through an informal "deficiency letter" or by instituting refusal order or stop-order proceedings.[105] As Professor Loss says: "While in theory the Commission's staff merely 'suggests' amendments, the practicabilities of financing do not allow any real alternative of complying."[106]

Moreover, the Commission may also be in a position to impose some substantive conditions by use of the coercive power to deny acceleration.[107] The registration statement becomes effective on the twentieth day following its filing or the filing of any amendments thereto, and the time runs from the filing of each amendment. The Commission may grant or deny acceleration "having due regard to the adequacy of the information respecting the issuer theretofore available to the public, to the facility with which the nature of the securities to be registered, their relationship to the capital structure of the issuer and the rights of holders thereof can be understood, and to the public interest and the protection of investors."[108] Where acceleration is essential for business reasons, the language gives the Commission considerable latitude to impose some substantive regulation which goes beyond mere disclosure, as any lawyer who has been confronted with the use of this power can attest. And as Professor Davis point out, judicial review is impracticable, if not nonexistent.[109]

The acceleration weapon, however, is most effective when least required and is relatively impotent in cases of the greatest need. Acceleration is absolutely essential only where the securities are of sufficient soundness that a responsible underwriter is willing to give a firm commitment, if only for a limited period. The risks are too great for these underwriters to court the disasters which may ensue from failure of the Commission to grant acceleration. On the other hand, in the case of promotional or more speculative ventures, there is not the same urgency, and the registrant is in a position to wait out all efforts of the Commission to wear it down through asserting deficiencies or through stop-order proceedings. Precisely this happened in the *Tucker* case, where the registrant even survived a stop-order proceeding and an opinion of the Commission which was apparently for the purpose of "warning" prospective investors.[110] Although the road may be long and weary and entail much

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of open, fair and careful dealing"); Consolidated Mines Syndicate, 2 S.E.C. 316, 323 (1937) (a write-up of assets without any basis in sound valuation is misleading).

[105] LOUIS LOSS, SECURITIES REGULATION 172 (1951).

[106] *Id.* at 175.

[107] See *id.* at 175-78.

[108] Securities Act of 1933, § 8(a), 48 STAT. 79, 15 U.S.C. § 77h(a) (1952).

[109] KENNETH C. DAVIS, ADMINISTRATIVE LAW § 42 (1951).

[110] Securities Act Release, *supra* note 96 at 3. The public failed to understand or heed the warning. Between 1946 and 1948, the Tucker Corporation raised some $26,000,000 in cash through the sale of franchises, stock, and auto accessories, mostly through the sale of stock at five dollars a share. By 1948, the company was bankrupt, and most of the investors' funds were lost. The registration statement became effective despite the "suspicions" of the SEC, which considered itself helpless to do more under a disclosure statute. See *Study of the Securities and Exchange Commission,* H.R. No. 2508, 82d Cong., 2d Sess. 18, 22-23, 24-29 (1952); Velie, *The Fantastic Story of the Tucker Car,* Collier's, June 25, 1949, p. 13. But the state blue-sky administrators were also unable to cope with this bizzarre episode. Only California barred sale of the stock as "a fraud upon the purchasers," $3,000,000, or fifteen per cent of the issue of $20,000,000, having been slated for sale in that state. See N.Y. Times, Aug. 1, 1947, p. 28, col. 3; Velie, *supra* at 15, 71.

time and expense, there is a very substantial number of issues which ultimately clear the Commission under its standard of full disclosure, but cannot meet the more exacting substantive standards imposed under the blue-sky laws of a number of states.[111]

The view is widely held that the securities regulation at the federal level should be confined to the milder disclosure philosophy for a variety of reasons. Some believe that it would be unwise to give the Commission a broader power to pass upon the "fairness" of securities issues, on the ground that this would give it "life-and-death power over virtually the entire industry of the country. . . ."[112] In view of the sharp differences in attitude *vis-à-vis* regulation in various sections of the country, there seems little likelihood in the near future of any expansion of the powers of the SEC in this area. Moreover, any such change would be impracticable and unwieldy without a far greater degree of administrative decentralization within the SEC than now exists, for its success would depend upon administration at the grass roots rather than from Washington.

A number of states, however, have experimented with securities statutes which do impose a considerable measure of substantive regulation upon issuers, and it is believed that these statutes hold the key to effective corporate regulation at the state level.

4. *Qualification of securities with varying degrees of substantive regulation*

This type of securities statute places less reliance upon disclosure to prospective investors and undertakes a greater degree of substantive regulation. These statutes range from the milder Uniform Sale of Securities Act, adopted by the Commissioners on Uniform Laws in 1930[113] and withdrawn in 1943,[114] and its successor, the new Uniform Securities Act of 1956,[115] to more far-reaching systems of securities regulation, such as that found in the California Corporate Securities Law.[116] At the risk of overgeneralization, the essential difference in the new Uniform Securities Act

[111] The statistics under the Illinois Securities Law of 1933 are illustrative.

	1954	*1955*	*1956*
Applications filed	155	158	198
Applications withdrawn for failure to qualify	17	30	20
Applications withdrawn in Illinois but registered with the SEC	10	18	14

See ILL. SECURITIES DEP'T ANN. REP. 14-15 (1954); *id.* at 16-18 (1955); *id.* at 8-10 (1956). Furthermore, it is the view of the Illinois Securities Department that these data do not tell the complete story, since many issuers who have registered their securities under the Federal Securities Act "do not even bother to file . . . [under the Illinois statute] because of the additional statutory safe-guards to the public required by such Law." *Id.* at 15 (1954). Although the Illinois record may not be typical, since it is generally regarded as a leading state in its blue-sky administration, the conclusion seems inescapable that securities regulation in a number of states is far more effective than that of the SEC, especially with respect to promotional ventures. See *Hearings, supra* note 90, at 275-90, *passim.*

[112] Address by Louis Loss, Mexico Stock Exchange, June 6, 1957, at 12. *Cf.* Joslin, *Federal Securities Regulation from the Small Investors' Perspective,* 6 J. PUB. L. 219 (1957).

[113] 9 U.L.A. 625 (1942).

[114] NAT'L CONFERENCE OF COMM'RS ON UNIFORM STATE LAWS, HANDBOOK 81 (1943).

[115] LOUIS LOSS AND EDWARD COWETT, BLUE SKY LAW 245 (1958).

[116] CAL. CORP. CODE §§ 25000-6104.

and the California statute is that the former concentrates upon fraud prevention (although it goes somewhat further in this respect than the Federal Securities Act), while the California statute may be regarded as an integral part of a broad scheme for correcting some of the inequities and defects which may otherwise arise in the practices of corporation finance. In order to compare this difference in approach, a brief description of the California system is necessary.

a. The California Corporate Securities Law—a maximum regulation statute.

(1) *Theory and scope.* The California statute combines broker-dealer regulation,[117] fraud prevention,[118] and disclosure[119] with administrative supervision over sales or issues of new securities in the state by an issuer; alteration of outstanding securities through charter amendments;[120] and exchanges of securities effected through merger, consolidation, or voluntary recapitalization.[121]

This pattern of regulation stems from a number of key provisions. With minor exceptions not of general application, no company may sell or offer for sale any security of its own issue in the state until it has applied for and secured a permit from the Corporation Commissioner authorizing the transaction.[122] Every security of its own issue sold or issued by a company without such a permit is void, as are securities sold or issued in nonconformity with any provision of a permit which has been previously obtained.[123]

A "sale" is defined not only to include offers and dispositions of securities for value, but also exchanges of securities and "any change in the rights, preferences, privileges, or restrictions on outstanding securities,"[124] thereby sweeping within its ambit all such changes effected by direct charter amendment, merger, consolidation, and voluntary recapitalizations.[125] Since the statute applies to issues as well as sales,

[117] *Id.* §§ 25700-13.

[118] *Id.* §§ 25507, 26104(e). There is, however, no specific section prescribing civil liability for violations of the statute. See Dahlquist, *Regulation and Civil Liability Under the California Corporate Securities Act: III*, 34 CALIF. L. REV. 543 (1946). Other articles in this series written by this leading member of the California corporate bar are found at: 33 *id.* at 343 (1945); 34 *id.* at 344 (1946); and *id.* at 695.

[119] CAL. CORP. CODE §§ 25600-04.

[120] *Id.* § 25009(a).

[121] *Id.* § 25510. The statute establishes a Division of Corporations, the administrative head of which is the Commissioner of Corporations. According to information received from the Commissioner, the Division has approximately 140 employees, as compared with a total SEC personnel of 784, of whom 484 are located in Washington, D.C., and only 300 in the field. See SEC ANN. REP. 197 (1957). The Division maintains offices in Los Angeles, Sacramento, and San Francisco. Over the years, fees have been adjusted with a view to meeting all costs of administering the statute, including enforcement activities. As a result of increased business activity in recent years, however, receipts from fees have exceeded the amounts appropriated for support of the agency. CALIF. STATE BUDGET, JULY 1, 1958-JUNE 30, 1959, at 518. A prominent member of the California corporate bar has called it "one of the model statewide regulatory agencies." Dahlquist, *Regulation and Civil Liability Under the California Corporate Securities Act*, 33 CALIF. L. REV. 343 (1945). *Cf.* Armstrong, *The Blue Sky Laws*, 44 VA. L. REV. 713, 720 (1958).

[122] CAL. CORP. CODE § 25500.

[123] *Id.* § 26100. For judicial modification of the "void" rule, see Dahlquist, *Regulation and Civil Liability Under the California Corporate Securities Act: III*, 34 CALIF. L. REV. 543, 551-60 (1946); LOUIS LOSS, SECURITIES REGULATION 962-64 (1951).

[124] CAL. CORP. CODE § 25009(a).

[125] See also *id.* § 25510.

a permit is required even for the issuance of a share dividend.[126] Stock splits also require a permit.[127]

The theory is that every issue of securities offers an opportunity to create inequities among shareholders and that any general exemption would fail to give the protection which the minority or outside shareholders need. It is possible, for example, to shift voting power between classes of shares by means of a stock split, a reverse stock split, or a share dividend. Moreover, a share dividend of preferred on common might have the effect of diluting the interest of the preferred as regards dividends, redemption, liquidation, conversion, and other rights. Shifts in priorities may also be effected through share dividends. Accordingly, rather than relying upon the class or other voting provision in the general corporation statute of the state, the Commissioner is vested with the power to review these transactions as to fairness. While, at first glance, these provisions may seem unduly to hamper legitimate business, experience has shown that enough cases arise where supervision is needed to justify the inconvenience.

The statute[128] and the rules and regulations[129] prescribe the contents of the application, the purpose of which (with the accompanying exhibits) is to furnish the Commission with material information necessary to appraise such matters as the nature of the business to be conducted, qualifications of the proposed management, whether the venture will be adequately capitalized, amounts of promotion securities proposed to be issued compared to funds from outside investors, proposed selling expenses, possible inequities between classes of shares, and whether the reports of engineers, appraisers, or other experts are adequate. The application is not a registration statement or a prospectus which is to be furnished to prospective purchasers as a selling document; it is prepared for the use of the Commissioner in determining whether a permit should be granted or denied. Accordingly, the document is much simpler than a registration statement or prospectus and less costly to prepare.[130]

The greatest departure from concepts of fraud prevention and disclosure, however, are to be found in the standards prescribed by the Commissioner for authorizing and denying permits. On original issues of securities, the Commissioner is to issue a permit only if he finds "that the proposed plan of business . . . and the proposed issuance of the securities are fair, just, and equitable, that the applicant intends to transact its business fairly and honestly," and that the securities proposed to be issued and the methods of issuing and disposing of them "are not such as, in his

[126] See Dahlquist, *Regulation and Civil Liability Under the California Corporate Securities Act*, 33 CALIF. L. REV. 343, 351 (1945).

[127] *Ibid.* For the controversy whether the "sale" of treasury shares is an "issue" of a new security, see Dahlquist, *Regulation and Civil Liability Under the California Corporate Securities Act: II*, 34 *id.* at 344, 374, 379 (1946); Ballantine, *The Curious Fiction of Treasury Shares*, *id.* at 536.

[128] CAL. CORP. CODE §§ 25502-05.

[129] CAL. ADM. CODE tit. 10, c. 3, subc. 2, §§ 318-32. These rules and regulations are reprinted in 1 CCH BLUE SKY L. REP. ¶¶ 8611-51 (1954).

[130] The cost of compliance with state and federal securities regulation is especially acute for small business. See Murphy, *The Big Worry of Small Business: Money*, Fortune, July 1957, pp. 120, 122, 123; LOUIS LOSS, SECURITIES REGULATION 400-03 (1951); *id.* at 400-01 (Supp. 1955).

opinion, will work a fraud upon the purchaser"; otherwise, he shall deny the application, refuse the permit, and notify the applicant in writing of his decision.[131] In cases of issues of securities in exchange for outstanding securities, claims, and other property interests, including cash, pursuant to a merger, consolidation, or voluntary recapitalization, application for approval must be made to the Commissioner, who is authorized to approve the terms and conditions of the exchange, after a hearing on the fairness, at which all persons to whom it is proposed to issue such securities may appear. After the hearing, the Commissioner may refuse the permit "if in his opinion the plan is not fair, just, or equitable to *all* security holders affected.[132] Thus, all issues are subjected to the litmus test of fairness to the entirety of the security holders affected.[133]

(2) *Function and contents of the permit.* Unlike the Federal Securities Act and other registration statutes, the Commissioner does not "register" the securities by making an order to that effect or by entering the securities in a register;[134] he issues, instead, a written permit to the applicant authorizing the issue or sale of the securities. The permit generally contains: (1) recitals which are somewhat comparable to a summary prospectus; (2) the authority to issue or sell the securities, setting forth the price, maximum selling expense (including commissions), the methods and terms of payment, and the purpose to which the proceeds shall be applied; and (3) the conditions imposed in the permit, if necessary, to make the proposed issue of securities "fair, just, and equitable."[135]

The conditions are most commonly imposed in connection with promotional and highly speculative ventures.[136] First, the amount of "promotional shares" which may be issued is limited and may not exceed an ultimate right to participate in dividends and assets of more than fifty per cent.[137] Promotion shares include contemporaneous sales of "cheap stock" to promoters and underwriters at a price substantially below the public offering price, as well as prior sales of such stock, unless a change of conditions since the time of issuance justifies the differential between the price of the earlier sale and the current offering price to the public.[138] They also

[131] CAL. CORP. CODE § 25507.

[132] *Id.* § 25510. (Emphasis added.). For an evaluation of the California system as compared to judicial control, see Orschel, *Administrative Protection for Shareholders in California Recapitalizations*, 4 STAN. L. REV. 215 (1952). And see Dahlquist, *Regulation and Civil Liability Under the California Corporate Securities Act: II*, 34 CALIF. L. REV. 344, 350-62 (1946).

[133] See, *e.g.*, In the Matter of Richardson Corporation, Cal. Corp. Comm'r. File No. SF 622275, SF 31266 (1948), discussed in Orschel, *supra* note 132, at 223. In determining that a statutory merger was not "fair" to all of the security holders affected, the Commissioner took cognizance of the fact that the vote of preferred shareholders included the vote of controlling persons with an adverse interest. See SEC, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL, AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES pt. 7, at 148-87 (1938); *cf.* Gibson, *supra* note 29, at 621.

[134] *Cf.* UNIFORM SALE OF SECURITIES ACT OF 1930, § 8, 9 U.L.A. 625, 641 (1942); UNIFORM SECURITIES ACT § 304(c), LOUIS LOSS AND EDWARD COWETT, BLUE SKY LAW 305 (1958).

[135] CAL. CORP. CODE §§ 25507-09.

[136] See generally CAL. ADM. CODE tit. 10, c. 3, subc. 2, §§ 368-421.

[137] *Id.* §§ 368.2, 368.6.

[138] *Id.* § 368.

embrace shares issued for past services or for intangible assets of unproven value because of the absence of an established earnings record.[139] Second, promotion shares are ordinarily limited to common shares, as to which a number of conditions are imposed in the permit. If the promotion shares may, as a class, elect a majority of the board of directors, a condition is imposed that the voting right as a class terminates if the company fails to pay an annual dividend of at least five per cent on its outstanding shares (exclusive of promotion shares) for two years, whether or not consecutive.[140] They must carry a waiver of dividend rights (currently five per cent) until the shareholders who have paid cash or its equivalent receive such a dividend, which is cumulative, after which the promotion shares receive a similar dividend; thereafter, all shares participate ratably.[141] The right to participate in assets upon liquidation is also waived until the shareholders who have paid cash or its equivalent receive back their investment.[142] Third, a new company financing by a public offering of securities may be compelled to impound a minimum amount of proceeds deemed necessary to launch the enterprise until the specified amount is raised.[143] Finally, to prevent the promoters from "bailing out" by selling their stock and walking off from the enterprise while it is still in the promotional stage, promotion shares must be placed in escrow with an escrow holder approved by the Commissioner, and transfers are allowed only with his permission.[144]

Other conditions may be imposed where vitally necessary to make the securities "fair, just, and equitable." For example, selling expenses are limited to twenty per cent of the selling price. They include indirect forms of compensation to promoters and underwriters, such as stock options, warrants, and other forms of "banditry" which would permit the siphoning off of an excessive amount of profits if the venture should prove successful.[145] The price to the public may itself be limited where the ratio of the proposed offering price to past earnings is unreasonably excessive.[146]

(3) *Scope of exemptions.* The California statute follows the usual pattern of exempting certain securities and certain transactions, irrespective of the type of security, but the nature and scope of these exemptions are more limited than is customary in two important respects. First, there is no exemption of new issues of securities simply because they have been previously listed upon a national securities exchange. The theory is that merely listing a security for trading confers no badge

[139] *Ibid.*
[140] *Id.* § 368.5, 373. The regulations are silent as to whether any right of reinstatement exists.
[141] *Id.* § 372.
[142] *Ibid.*
[143] *Id.* §§ 393-402.
[144] *Id.* §§ 370-71.
[145] *Id.* §§ 349-56.
[146] *Id.* §§ 337-45. The Commissioner will grant exceptions to his rules on application for a closed permit, where the prospective purchasers are informed investors, if all shares are escrowed so that subsequent sales need his consent. See HENRY W. BALLANTINE AND GRAHAM L. STERLING, JR., CALIFORNIA CORPORATION LAWS § 461 (1949).

entitling it to immunity from regulation. The *Great Sweet Grass* swindle,[147] involving a security listed on the American Stock Exchange, is a recent classic example which proves the point. We live in an age of mergers, where shifts of control may take place quickly through such devices as a negotiated purchase, a sale of assets, a merger, or a stock acquisition.[148] Moreover, any such exemption would cut down the Commissioner's power to review voluntary recapitalizations, mergers, and consolidations for "fairness."

Second, the California statute rejects the idea of a small issues exemption of corporate securities, based upon private offers, amount of securities, or the number of offers or sales, the theory being that such exemptions are neither necessary nor advisable.[149] A "private-offering" exemption when applied to corporate securities has proved to be much too vague and susceptible of evasion.[150] Accordingly, in California, such offerings are screened by the Commissioner. In the case of a proposed private offering, an application may be made for a closed permit authorizing the sale of securities to a selected group of persons.[151] If the Commissioner is satisfied that the members of the group are reasonably informed investors, a closed permit is issued, authorizing the sale of a maximum amount of securities to any or all such persons. If a public offering is involved, the proper procedure is to request an open permit to make offers to the public indiscriminately.

The Commissioner's files reveal many reasons why an exemption based upon the number of offerees or volume of sales is rejected. For example, in one case, a California school teacher was induced to invest her life savings of $80,000 in a Texas insurance annuity promotion.[152] To exempt any such offer or sale would simply open up another avenue of escape from effective regulation and thus encourage fraud. Furthermore, a real danger exists that additional corporations might

[147] In the Matter of Great Sweet Grass Oils, Ltd. and Kroy Oils Ltd., Securities Exchange Act Release No. 5483, CCH FED. SEC. L. REP. ¶ 76,516 (1957); Klaw, *The Great Sweet Grass Swindle,* Fortune, Aug. 1957, p. 134.

[148] The mechanics of the *Great Sweet Grass* swindle revolved around an acquisition of control of a Canadian corporation by a Canadian promoter for an expenditure of $150,000. The corporation's shares were listed on the American Stock Exchange. The corporation, through a series of "mergers," subsequently issued, in Canada, some 2,800,000 shares, which were resold in the United States without SEC registration under a claim of exemption by virtue of SEC Rule 133, 17 C.F.R. § 230.133 (Supp. 1957). The returns to the promoters were approximately as follows: gross returns, $13,000,000; cost of shares to promoters, $3,500,000; commissions to boiler-room operators, $2,000,000; net profit to promoters, $7,500,000. See Klaw, *supra* note 147, at 178.

[149] Domestic & Foreign Pet. Co. v. Long, 4 Cal. 2d 547, 51 P.2d 73 (1935); Cecil B. DeMille Productions v. Woolery, 61 F.2d 45 (9th Cir. 1932).

[150] See In re The Crowell-Collier Publishing Co., Securities Act Release No. 3825, CCH FED. SEC. L. REP. ¶ 76,539 (1957); SEC v. Ralston Purina Co., 346 U.S. 119 (1953). On the difficulties in the SEC enforcement program, see 23 SEC ANN. REP. 1-9 (1957).

[151] See Domestic & Foreign Pet. Co. v. Long, 4 Cal.2d 547, 51 P.2d 45 (9th Cir. 1932); Dahlquist, *Regulation and Civil Liability Under the California Corporate Securities Act,* 33 CALIF. L. REV. 343, 359 (1945).

[152] Cal. Corp. Comm'r File No. SF K.P. Chartier (Alpha) (1955). The offer was made in California without a permit. Full restitution was eventually obtained. Compare the enforcement difficulties engendered by the "isolated sale" and "sale to stockholder" exemptions found in the Florida statute. FLA. STAT. ANN. § 517.06(3) and (4) (Supp. 1957), discussed in Robinton and Sowards, *The Florida Securities Act: A Re-Examination,* 12 MIAMI L. Q. 1, 4-5 (1957).

be proliferated merely to take advantage of any such exemption. In view of these possibilities, it seems unrealistic to rest an exemption either upon the number of offerees or upon the volume of sales. The legislative policy appears to be based upon the theory that the closed permit procedure provides a safety valve for small issues, without unduly hampering legitimate business or releasing most of the steam from the Commissioner's enforcement machinery in this area.

(4) *The problem of the foreign issuer.* A necessary step in preparing a nationwide distribution of securities is that of coordinating the SEC registration with the blue-skying at the state level. Under the California statute, a permit to issue or sell securities must be obtained if the issuer is a California corporation, regardless of where the sale or issue takes place.[153] Suppose, however, *X*, a Delaware corporation, with its principal place of business in New York and with numerous shareholders residing throughout the United States, including California, proposes to market an issue of securities on a national basis. The securities will be underwritten under a firm commitment, and the underwriters will resell the securities either directly or through selected dealers. The shares will be registered with the Securities and Exchange Commission. The closing will take place in New York, and the shares will be resold in California by licensed California brokers and dealers.

Since a secondary rather than a primary sale in California is entailed, no application for a permit for the corporation to issue or sell the securities is necessary; the only general requirement under the statute is that advertising literature to be used in California by brokers or dealers be filed with the Commission at least one day prior to use.[154] The usual practice is for one of the principal underwriters who is a registered California dealer to file the prospectus and other advertising and selling material with the Commissioner shortly after filing the registration statement with the SEC. If the securities and the terms of sale meet the Commissioner's standards, the underwriters are advised that the material may be used upon supplying any missing data, such as the price. Frequently, the dealer furnishes this information by telegram. On the other hand, if the Commissioner, after a review of the prospectus, finds that the sale of the security would be "unfair, unjust, and inequitable," he may notify brokers and dealers to that effect in writing, and sales in California are thereafter forbidden until the Commissioner subsequently withdraws his objection.[155]

The practical result is that most national issues of foreign issuers registered with

[153] See Dahlquist, *Regulation and Civil Liability Under the California Corporate Securities Act: II*, 34 CALIF. L. REV. 344, 384 (1946). When the articles of incorporation of a California corporation are filed with the Secretary of State, he gives notice of this requirement. And see CAL. CORP. CODE § 4113 as to filing of a "certificate of clearance" from the Corporation Commissioner in case of merger or consolidation.

[154] CAL. CORP. CODE § 25602; CAL. ADM. CODE tit. 10, c. 3, subc. 2, §§ 840-842; see Dahlquist, *Regulation and Civil Liability Under the California Corporate Securities Act: II*, 34 CALIF. L. REV. 344, 380-84 (1946).

[155] CAL. CORP. CODE § 25707. It is this rather obscure section which plugs a supposed loophole which Professor Loss has noted in the California statute with respect to the secondary sale of securities. See LOUIS LOSS AND EDWARD COWETT, BLUE SKY LAW 204 (1958).

the SEC and sold under a firm commitment to responsible underwriters for resale in California can be processed without delay or difficulty. Problems will arise only where the issue fails to meet the Commissioner's substantive standards. If the securities are to be sold under a "best efforts" arrangement rather than a firm commitment, the Commissioner regards the underwriter as an agent of the issuer and the corporation itself must file an application for a permit.[156]

In case the *X* Corporation offers securities to its California shareholders, whether pursuant to a rights offering or an exchange offer to be made in connection with a voluntary recapitalization, merger, or consolidation, a permit must be obtained from the Corporation Commissioner, since a "sale" takes place in the state.[157] It has also been seen that the statute embraces "issues" as well as "sales," so that even the issuance of a stock dividend to California shareholders requires a permit. The California Attorney General has ruled, however, that a foreign corporation doing no business in California may issue a true stock dividend to California shareholders without the necessity of a permit.[158] Thus, suppose that a Massachusetts corporation not doing business in California issues all of its shares to residents of Massachusetts. Later, a single shareholder moves to California. Under the Attorney General's ruling, no permit would be required to issue to him a stock dividend. Although the question is unresolved, it is believed that a contrary result would be reached if the foreign corporation were engaged in business, or maintained a commercial domicile, in California.[159] Various interested groups have so far been unable to agree on a formula to take care of the problem of the foreign issuer with an insubstantial number of California shareholders. It would seem feasible, however, to give the Commissioner statutory power to issue rules and regulations exempting some of these transactions, either by general rule or by order upon simple notification, if he finds that the enforcement of the statute with respect to such transactions is not necessary in the public interest or for the protection of investors.[160]

The broad control over foreign issuers found in the California statute has one final value. It enables the Commissioner to impose minimum standards for securities upon foreign corporations who choose to issue or sell securities in California. He has always used this power sparingly. For example, although mandatory cumula-

[156] See Dahlquist, *Regulation and Civil Liability Under the California Corporate Securities Act: II*, 34 CALIF. L. REV. 344, 383 (1946).

[157] Professor Loss suggests that a failure to exempt an offering by a foreign issuer to existing shareholders pursuant to pre-emptive rights may be unconstitutional under the commerce clause. LOUIS LOSS AND EDWARD COWETT, BLUE SKY LAW 377 (1958). As regards foreign issuers not doing business in the state, it would seem that primarily due process considerations are involved and that these are probably insubstantial. *Cf.* Travelers Health Association v. Virginia, 339 U.S. 643 (1949); McGee v. International Life Insurance Co., 355 U.S. 220 (1957).

[158] Op. Cal. Att'y Gen., Oct. 8, 1929; *cf.* 17 OPS. CAL. ATT'Y GEN. 217, 222, 223 (1951); LOUIS LOSS AND EDWARD COWETT, BLUE-SKY LAW 204 (1958). For conflict-of-laws problems, see the excellent article of Loss, *The Conflict of Laws and the Blue Sky Laws*, 71 HARV. L. REV. 209 (1957), reprinted in LOSS AND COWETT, *op. cit. supra* c. 5.

[159] See Dahlquist, *Regulation and Civil Liability Under the California Corporate Securities Act: II*, 34 CALIF. L. REV. 344, 385 (1946).

[160] *Cf.* Securities Act of 1933, § 3(b), 48 STAT. 75, as amended, 15 U.S.C. § 77c (1952).

tive voting has been a state policy for domestic corporations since 1879,[161] foreign or quasi-foreign corporations have not been compelled to insert a cumulative voting clause in their articles of incorporation where cumulative voting is permitted but not required by the state of incorporation. In October 1956, however, Western Airlines, Inc., a Delaware corporation, sought to amend its certificate of incorporation to eliminate cumulative voting.[162] The company operates airlines in twelve western states, but none in Delaware.[163] Its shares are owned by some 7,000 shareholders residing in every state in the Union and in several foreign countries, but its principal headquarters are located in California and it has many California shareholders.[164] At the time of the sale and issuance of its shares to California residents pursuant to a permit from the Corporation Commissioner, the Company's certificate of incorporation allowed cumulative voting for directors. At the annual meeting of stockholders, held in April 1956, a group opposing the management elected two of the corporation's thirteen directors by the use of cumulative voting. Steps by the management to eliminate that right followed. The proposed amendment was approved at a special meeting at which approximately eighty-seven per cent of the shares voted, fifty-nine per cent voting for and twenty-eight per cent voting against the amendment. In view of this substantial opposition,[165] early in 1957, the California Corporation Commissioner twice denied the company's application for a permit to change the rights of the outstanding shares in this respect, the theory apparently being that such modification would be unfair and inequitable to those California shareholders who might, by cumulating their votes, obtain representation on the board. A petition by the company to the Los Angeles Superior Court resulted in referring the matter back to the Commissioner for another hearing, and the matter is still pending. If the Commissioner's position is sustained, it will clear up existing doubts as to the power of the Commissioner to impose reasonable conditions upon foreign corporations who choose to market their securities in California and to supervise voluntary reorganizations, recapitalizations, and mergers. It will also point the way for a state to use a securities statute as a regulatory device to prevent the circumvention of its general corporation statute by out-of-state incorporation.[166]

b. *The Uniform Securities Act—a "mild" regulation statute.* The new Uniform Securities Act is the third attempt to achieve uniformity in the area of state securities regulation. In 1930, the National Conference of Commissioners on Uniform State Laws and the American Bar Association approved a Uniform Sale of Securities

[161] CAL. CONST. art. xii, § 12 (1879), formerly made cumulative voting for directors mandatory. Wright v. Cent. Cal. C. W. Co., 67 Cal. 532, 8 Pac. 70 (1885). Although this section was repealed in 1930, the right was preserved by statute. CAL. CORP. CODE § 2235.

[162] See WESTERN AIRLINES, INC., ANN. REP. 6 (1956).

[163] See WALKER'S MANUAL OF PACIFIC COAST SECURITIES 463 (1957).

[164] *Id.* at 464; WESTERN AIRLINES, INC., ANN. REP. 6 (1956).

[165] See WESTERN AIRLINES, INC., ANN. REP. 6 (1956); Cal. Corp. Comm'r File No. SF 4053 (1956).

[166] The Chairman of the ABA Committee on Corporation Laws finds this statutory solution "ridiculous" and suggests a hard "sell" by corporations to eradicate it. Seward, *supra* note 68, at 34.

Act.[167] The Act was not an outstanding success,[168] and in 1943 it was dropped from the list of Uniform Acts.[169]

In 1947, a second effort was made by the same agencies, working through a joint committee of practicing lawyers composed of members of the Conference Section and the Committee on State Security Laws and Regulations of the American Bar Association Section on Corporation, Banking, and Mercantile Law.[170] This committee prepared three tentative drafts of a Uniform Securities Act,[171] but a hopeless deadlock ensued between industry representatives and some blue-sky lawyers, on the one hand, who took the view that the draftsmen were too regulation-minded, and state securities administrators, who were convinced that the movement was designed to strip the regulators of their essential powers.[172] In view of this impasse, the third draft was withdrawn at the 1953 meeting of the National Conference, and it was recommended that a "thorough background study" should be made and cooperation sought from the National Association of Securities Administrators.[173]

[167] UNIFORM SALE OF SECURITIES ACT OF 1930, 9 U.L.A. (1942).

[168] The Act was adopted with modifications in Florida (1931), Hawaii (1931), South Carolina (1937), Oregon (1939), and Louisiana (1940). 9 U.L.A. 289 (Supp. 1950).

[169] *Supra* note 114.

[170] 72 A.B.A. REP. 98 (1947). For an account of the work of this committee, see Blair-Smith, *More on the Project for a Uniform Securities Act,* Business Lawyer, July 1956, p. 111.

[171] These drafts (1949, 1951, and 1953) apparently were published in mimeograph form. Only the last two drafts have been available to the writer. See NAT'L CONFERENCE OF COMM'RS ON UNIFORM STATE LAWS, UNIFORM SECURITIES ACT (2d tentative draft 1951); *id.* (3d tentative draft 1953); Blair-Smith, *supra* note 170, at 112.

[172] See Blair-Smith, *supra* note 170, at 112.

[173] *Id.* at 113. How the deadlock was broken is somewhat obscure, but it undoubtedly hinged upon the decision to prepare a tripartite act representing the three different approaches to state securities regulation. See note 178 *infra.*

The source of the three-part structure is less puzzling. Mr. Murray Hanson, general counsel of the Investment Bankers Association of America, in 1947 suggested two uniform acts—one of the "fraud" type and one of the "dealer-registration" type, "so that basically there would be a model law available of whichever of the current types the people of a given state might desire." Hanson, *The Need for Uniformity in Our Securities Laws,* in NAT'L ASS'N OF SECURITIES ADM'RS, PROCEEDINGS 55 (1947), reprinted in 166 COM. & FIN. CHRON. 1420 (1947). In 1951, Professor Loss picked up the ball, but suggested the possibility of "*three* new acts, one for each of the three types of states," as he had then classified them. LOUIS LOSS, SECURITIES REGULATION 45 (1951).

Professor Loss has also shed light on the deadlock-breaking episode at the 1953 meeting of the National Conference: "The 1953 meeting of the Conference was held in Boston, and Commissioner Edward L. Schwartz of the Boston Bar, Chairman of the Conference's Subcommittee on the Uniform Securities Act, invited me to attend the meeting of the parent section of the Conference. That section disapproved the third draft—and was about to recommend to the Conference that the entire idea of a uniform or model securities statute be dropped—on the ground that the legislative philosophies of the states were too diverse. But the members reconsidered when it was suggested that a model statute might be drafted in several parts, each corresponding to one of the basic regulatory philosophies. Thus, Part I might deal with fraud, Part II with broker-dealer registration and Part III with securities registration. Then a fourth part might contain the general provisions (definitions, exemptions, rule-making powers and so on) which would be essential under any of the philosophies. Under this scheme of things a state like New Jersey which wanted to continue with a pure "fraud" philosophy might adopt only Parts I and IV; a state like Pennsylvania which wanted to combine anti-fraud provisions with a system of broker-dealer registration might adopt Parts I, II, and IV; and most of the states, which follow all three philosophies, might consider the entire statute. This basic approach—I wish I could say it were my own, but it has a rather mixed paternity—was received with some enthusiasm, and the Conference's committee was instructed to prepare a fourth draft accordingly." NAT'L ASS'N OF SECURITIES ADM'S, PROCEEDINGS 37 (1954).

The upshot was that in July 1954, the Harvard Law School undertook such a study under the direction of Professor Louis Loss, assisted by Mr. Edward M. Cowett.[174] A proposed Uniform Securities Act with final draft and commentary was published two years later.[175] The prestige of the Harvard Law School and the eminence of Professor Loss in the field of federal securities regulation give the study a special significance, and it is likely to have a wide influence upon state securities legislation in the coming years.[176] It seems unnecessary to praise the many good features of the new Act, including the ingenious statutory proposal for solving the conflict-of-laws problems in the regulation of interstate sales of securities.[177] The policy questions in any such proposal, however, are of such paramount importance that it seems appropriate and permissible to attempt a critical analysis of the basic provisions which have been framed to displace existing state legislation.

(1) *Theory and scope*. A unique feature of the new Act is that it rejects the idea of complete uniformity in favor of what is essentially a three-part structure representing the three basic approaches to regulation: (1) fraud prevention, (2) broker-dealer regulation, and (3) registration or qualification of securities where an administrator has the specific duty to examine the securities and the power to exclude securities which fail to meet the state's minimum standards. The theory is that although a state may adopt only one or a combination of these regulatory schemes, if the Act should receive widespread acceptance, there will at least be uniformity within any particular system.[178]

The quest for uniformity seems to have resulted from the "needless complexities" of the state securities statutes.[179] Professor Loss has said: "This welter of diverse state laws make one almost literally scream for a uniform act—especially if he happens to be preparing an issue for nationwide distribution."[180] Some law office juniors who are responsible for blue-skying a nation-wide offering and coordinating it with an SEC registration may be surprised to learn that the accomplishment of this objective "has some of the aspects of a minor miracle."[181] Since the fraud-type statutes pose no problems from the standpoint of uniformity and broker-dealer regulation offers problems of only minor significance, it is apparent that efforts at cor-

[174] *Ibid.* For further background, see Loss and Cowett, *An Interim Report on the Harvard Law School Study of State Securities Regulation*, Business Lawyer, Jan. 1955, p. 15, *passim;* Loss, *Current Status of the Uniform Securities Act*, 12 *id.* at 26 (1956).

[175] LOUIS LOSS AND EDWARD COWETT, A PROPOSED UNIFORM SECURITIES ACT—FINAL DRAFT AND COMMENTARY (1956). See note 3, *supra.* The new Uniform Securities Act will hereinafter be cited as the UNIFORM SECURITIES ACT—1956.

[176] The Uniform Securities Act—1956 has been adopted with modifications in Kansas (1957) and Hawaii (1957). Virginia patterned its 1956 statute upon an earlier draft. Seven other states have adopted one or more sections of the Act. See LOUIS LOSS AND EDWARD COWETT, BLUE SKY LAW app. II (1958).

[177] UNIFORM SECURITIES ACT—1956, § 414. See Loss, *The Conflct of Laws and the Blue Sky Laws*, 71 HARV. L. REV. 209 (1957), reprinted in LOUIS LOSS AND EDWARD COWETT, BLUE SKY LAW c. 5 (1958).

[178] LOUIS LOSS AND EDWARD COWETT, BLUE SKY LAW 236-38 (1958).

[179] Loss and Cowett, *An Interim Report on the Harvard Law School Study of State Securities Regulation*, Business Lawyer, Jan. 1955, p. 15.

[180] LOUIS LOSS, SECURITIES REGULATION 44 (1951).

[181] Address by Louis Loss, Mexico Stock Exchange, June 6, 1957, at 7.

rective measures through the medium of uniformity would have to center upon the provisions relating to registration of securities.[182]

The system for registration of securities follows the pattern established in the earlier Uniform Acts. As in the 1930 and 1953 drafts, securities may be registered by notification[183] and by qualification.[184] They may, however, also be registered by coordination, a new concept developed to correlate state securities registration with registration under the Federal Securities Act of 1933.[185]

The simple notification procedure is available to companies which have been in existence for at least five years and which for the preceding three years have not defaulted on any senior security and have had average earnings of at least five per cent on the common shares.[186] This procedure may be used irrespective of any changes in management or other conditions which may make the statutory tests unreliable. Registration by notification becomes effective two full business days after the filing of a statement or an amendment, in the absence of a stop order proceeding or the order itself.[187]

Under the coordination method, the registration statement filed under the Federal Securities Act of 1933 may be used to effect state registration for the same offering.[188] One objective of the coordination procedure is to streamline compliance with the state statute ***"without sacrificing the traditional regulatory philosophy of the states to the disclosure philosophy of the federal statute."***[189] Another is to avoid "a mad last-minute mass of telephone calls and telegrams in order to make certain that the issue is cleared with the states by the time the registration statement becomes effective at the SEC."[190] These purposes are accomplished by making the state registration statement operative at the moment the federal registration statement becomes effective, if (1) no stop order has been issued; (2) the registration statement has been on file with the state administrator for ten days; and (3) a statement of the

[182] See Blair-Smith, *supra* note 170, at 112. James E. Dunlap, of the Los Angeles bar, has pointed out that "most of the pressure for the uniform law [Uniform Securities Act—1956] has come from the large brokerage houses and their attorneys who are well acquainted with the laws of all 48 states." Dunlap, *Uniformity Achieved by Proposed Uniform Securities Act*, in LOS ANGELES BAR ASS'N COMM. ON CORPORATIONS app., at 1 (1957).

[183] UNIFORM SALE OF SECURITIES ACT OF 1930 § 7, 9 U.L.A. 635 (1942); UNIFORM SECURITIES ACT § 4-1 (3d tentative draft 1953) (called registration by description).

[184] UNIFORM SALE OF SECURITIES ACT OF 1930, § 8, 9 U.L.A. 643 (1942); UNIFORM SECURITIES ACT § 5-1 (3d tentative draft 1953).

[185] *Cf.* Smith, *supra* note 84, at 252-55; Wright, *supra* note 84; LOUIS LOSS, SECURITIES REGULATION 44-88 (1951).

[186] UNIFORM SECURITIES ACT—1956, § 302.

[187] *Id.* § 302(c).

[188] *Id.* § 303.

[189] LOUIS LOSS AND EDWARD COWETT, BLUE SKY LAW 291 (1958). (Emphasis by authors.)

[190] *Ibid.* It is believed that Professor Loss greatly exaggerates the mechanical problem. While time, paper work, and telephone and telegraph expenses are necessary to blue-sky a nationwide issue, when weighed against the other tasks of the lawyer in getting out the issue, they are of minor magnitude. *Cf.* Dean, *The Lawyer's Problems in the Registration of Securities*, 4 LAW & CONTEMP. PROB. 154, 176 (1937). And the State Securities Administrators have done much to improve the situation. LOUIS LOSS AND EDWARD COWETT, BLUE SKY LAW 230-33 (1958). The question is not whether there should be more coordination, but how it should be achieved without emasculating state securities regulation.

maximum and minimum proposed offering prices and the maximum underwriting discounts have been on file for two full business days.[191] If the registrant advises the administrator of the date when the federal registration statement is expected to become effective, the administrator must promptly advise the registrant by telephone or telegraph, at the registrant's expense, whether all the conditions are satisfied and whether he then contemplates the institution of a stop order proceeding to deny, suspend, or revoke effectiveness under the Act.[192] The coordination procedure closely approximates the California procedure as to secondary sales, except that under the Uniform Act (as we shall see later), the administrator has only a very limited power to deny registration to an issue where SEC clearance has been obtained.

The third method of registration is by qualification. The information required to be filed is modeled on schedule A of the Federal Securities Act of 1933 and SEC Form S-1.[193]

The administrator may, by rule or order, require as a condition to registration by qualification or by coordination that certain promotion shares be escrowed.[194] These are limited to shares issued within three years or which are *to be issued* to a promoter for a consideration substantially different from the public offering price, as well as securities issued to any person for a noncash consideration. The three-year limitation opens the way for evasion by bankers and promoters who can keep corporate shells with outstanding promotion shares "on ice" for the requisite period.[195] The administrator may also require that the proceeds from the sale of a registered security be impounded until a specified amount is received.[196] It is to be noted, however, that the escrow and impound provisions do not require that promotion shares be subordinated to the outside shares in the event of liquidation—an ingredient of the 1930 Act—and are not made applicable to securities registered by notification. While the latter exception would not ordinarily be important, situations may arise where, as a result of a change in the character of the business or otherwise, such registrants are, in fact, issuing promotional securities which should be subordinated.

The crucial section of the new Act is section 306, which specifies the conditions under which the administrator may deny effectiveness to, or suspend, or revoke the effectiveness of a registration statement filed under any one of the three procedures—notification, coordination, or qualification. The Commissioner may issue any such order if he finds that it would be in the public interest to do so and that any

[191] UNIFORM SECURITIES ACT—1956, § 303(c).

[192] *Ibid.*

[193] *Id.* § 304(b); LOUIS LOSS AND EDWARD COWETT, BLUE SKY LAW 304 (1958).

[194] UNIFORM SECURITIES ACT—1956, § 305(g).

[195] The Illinois statute relating to the escrow of promoters' shares reaches back five years. The California statute has no time restriction. Indeed, the escrow provisions of this statute tie the hands of the administrator even more than does the Uniform Sale of Securities Act of 1930. *Cf.* UNIFORM SALE OF SECURITIES ACT OF 1930, § 14, 9 U.L.A. 649 (1942).

[196] UNIFORM SECURITIES ACT—1956, § 305(g).

one of nine other conditions are met.[197] There is carried over from the 1930 Uniform Act and the 1953 tentative draft the noncontroversial condition that "the offering has worked or tended to work a fraud upon the purchasers or would so operate."[198] Added is an important new condition that the offering may be halted if "it has been or would be made with unreasonable amounts of underwriters' and sellers' discounts, commissions, or other compensation, or promoters' profits or participation, or unreasonable amounts or kinds of options. . . ."[199]

Still absent from the Uniform Act, however, is the "fair, just, and equitable" standard which is to be found in the statutes of at least sixteen states, including all of those which have been the vanguard of securities regulation at the state level. In justification of this crucial omission, we are told: "Administrative flexibility is important in this area, but it must always be balanced against the proper claim of legitimate business to as great a degree of specificity as the public interest will permit."[200] In the "border-line cases which are not quite fraudulent," the regulators may order a prospectus to be used—the oral loophole being preserved—and rely upon full disclosure, as in the Federal Securities Act.[201] Professor Loss would, thus, scrap some two decades of successful experience in the application of the "fairness" standard in state securities regulation on the ground that it is "too vague."

Unsupported generalizations of a necessity for greater specificity are far less convincing than factual studies such as that of Mr. Albert K. Orschel on the administrative supervision of voluntary plans of corporate reorganization and recapitalization by use of the "fairness" standard.[202] In contrast with some of the current revelations regarding certain federal administrative agencies, not including the SEC, Mr. Orschel was impressed with the integrity and judgment of the California Commissioner and staff and concluded: "The result is a system in California which more

[197] These include: (1) omissions or misstatements of material facts in the registration statement; (2) willful violation of rules, orders, or conditions imposed in connection with the offering; (3) subsisting administrative stop orders or injunctions applicable to the offering under any other federal or state statute; and (4) illegality of the enterprise or method of business.

[198] UNIFORM SALE OF SECURITIES ACT OF 1930, § 8(i), 9 U.L.A. 642 (1942); UNIFORM SECURITIES ACT § 7-1(3) (tentative draft 1953).

[199] UNIFORM SECURITIES ACT—1956, § 306(F). For the revelations in congressional hearings held in 1955 and 1956 of enormous bankers' and promoters' profits during the uranium boom, see *Hearings, supra* note 90, at 35-36, 579, *passim*. Compare the 1946 Statement of Policy of the National Association of Securities Administrators relating to the granting of warrants or stock-purchase options to promoters and underwriters. NAT'L ASS'N OF SECURITIES ADM'RS, PROCEEDINGS 84 (1946). See 1 CCH BLUE SKY L. REP. ¶ 4571 (1945). For the SEC practice, see Universal Camera Corp., Securities Act Release No. 3076 (1945). A study by the Michigan Securities Commission is reported to have resulted in a finding that underwriters often profit more from the exercise of warrants or stock-purchase options than from the direct commissions received from the sale of securities. ILL. SECURITIES DEP'T ANN. REP. 19 (1954).

[200] LOUIS LOSS AND EDWARD COWETT, BLUE SKY LAW 327 (1958). For a defense of this omission by Professor Loss—a point which he finds "troublesome"—see NAT'L ASS'N OF SECURITIES ADM'RS, PROCEEDINGS 73-76 (1956). He notes that in all cases of registration by qualification the administrator may require that a prospectus be given to every buyer. UNIFORM SECURITIES ACT—1956, § 304(d).

[201] LOUIS LOSS AND EDWARD COWETT, BLUE SKY LAW 328 (1958).

[202] Orschel, *supra* note 132. Mr. Orschel, a member of a leading Chicago law firm with a quarter of a century of corporate practice, made this survey while a visiting professor at the Stanford Law School. Unfortunately, Orschel's paper appears to have escaped the attention of the draftsmen of the uniform act. See LOUIS LOSS AND EDWARD COWETT, BLUE SKY LAW app. IV (1958).

effectively protects security holders than have the courts in other states."[203] And he adds: "[E]ven if some may bridle at the use of an administrative agency, the annoyances and complaints which any such body of necessity draws to itself seem a reasonable price for a forward looking answer to a difficult legal problem."[204]

Indeed, lurking behind the movement for uniform legislation in state securities control is the distaste of a segment of the securities industry and the corporate bar for the "paternalistic" blue-sky legislation found in certain midwestern, southern, and western states which have adopted the "fair, just, and equitable" standard. If it is assumed that the states which either have little or no securities regulation will maintain their traditional position—and the tri-partite structure of the new Uniform Act envisages just this result—it is the "fairness" states which will be "leveled" should pressure groups operating under the banner of "promoting uniformity" succeed in displacing existing legislation with the new Act.[205] It is perhaps this feature of the Act which has caused one enthusiast to proclaim it to be "the greatest invention since the wheel."[206] Thus, for the Act to be an outstanding success and accomplish the objective of "uniformity," it must break down the more restrictive legislation of Illinois, Indiana, Michigan, Ohio, and Wisconsin in the Midwest, North Carolina and Texas in the South, and California, Washington, and Oregon in the Far West;[207] otherwise there is little point to the search for uniformity, except the puristic one of similarity as to terms, definitions, and the like. The experience of these states disproves the notion that the fraud test adopted by the Uniform Act plus limited control over promoters' and bankers' profits will provide a satisfactory base for effective securities regulation. There is a real danger that under the new Act, the courts will hold the fraud test to be applicable only to disclosures in the registration statement (including misstatements and omissions) and not sufficiently broad to proscribe unsound business ventures.[208] For example, would an alert administrator be able to halt a *Tucker* issue, as only California did in 1947?[209] Aside from his ability to impose escrow and impound conditions and to

[203] Orschel, *supra* note 132, at 236.

[204] *Id.* at 235.

[205] In California, the Committee on Corporations of the Los Angeles Bar Association, after a careful study of the Act, "has concluded that the Uniform Securities Act in its present form should be changed in a number of significant respects, particularly to provide necessary protection for California investors, and that as so changed the Uniform Securities Act would be a desirable blue sky law for California." Los Angeles Bar Ass'n, Comm. on Corporations, *The Uniform Securities Act*, 33 L.A. BAR BULL. 67, 88 (1958). For the view of a member of the Corporation Commissioner's staff, see Pearce, *California Corporate Securities Law vs. Proposed Uniform Securities Law*, 9 HASTINGS L.J. 1 (1957).

[206] Demmler, *Progress Toward a Uniform Securities Act: A Result of the Harvard Law School Study*, Harv. L.S. Bull., Oct. 1956, p. 16, 22.

[207] Other states using the "fair, just, and equitable" standard are: Alabama, Idaho, Montana, Nebraska, Tennessee, and West Virginia. Kansas, in adopting the new Uniform Act, no longer falls in this category.

[208] But see Statement of Professor Loss, in NAT'L ASS'N OF SECURITIES ADM'S, PROCEEDINGS 73 (1956). This standard is probably unnecessary if the "fair, just, and equitable" test is adopted. The "unsound business" criterion (but not that of "fairness") was inserted in § 10 of the Uniform Sale of Securities Act of 1930. Both were excluded from the 1953 tentative draft and the Uniform Securities Act—1956. *Cf.* UNIFORM SALE OF SECURITIES ACT OF 1930, § 10, 9 U.L.A. 644 (1942).

[209] See note 110 *supra*.

control promoters' and bankers' profits, the administrator would have no authority to prevent inequitable share structures or impose conditions as to waiver of dividend rights or the right to participate in assets on liquidation in an *Old Dominion* situation,[210] not only in case of registration by notification and by coordination, but also in all other circumstances.

Assuming that the fraud standard has some vague content beyond disclosure, it certainly would not embrace inequity and unfairness. As a result, an administrator's hands would be tied so that he probably could not directly[211] impose minimum standards relating to security provisions in potentially inequitable situations where there is a public offering of noncumulative preferred shares;[212] where a provision in a preferred share contract forbidding the corporation to purchase any preferred or common shares when dividends are in arrears does not impose a similar restriction upon subsidiaries;[213] where a preferred share contingent-voting provision provides that the voting right shifts upon the passage of four *consecutive* quarterly dividends, thereby permitting the postponement of a default by staggering the payment of dividends;[214] or where nonvoting common or preferred stock is offered to the public. One other example might be mentioned where the fraud limitation may not afford sufficient protection. A practice has developed in recent years of financing a new venture by selling redeemable, nonconvertible preferred shares to the public for cash, with the insiders taking the common, either for a slight cash investment or as promotion shares. Under this "heads-I-win, tails-you-lose" arrangement, the public investors not only bear the risk of business failure, but can be deprived of a share of the profits if the business succeeds. These examples will serve to indicate that there are countless situations where the administrator needs the power to deny registration on the ground that the proposed issue is not "fair, just, and equitable" to the outside shareholders. It is strange and unfortunate that a major objective of the drive for uniformity seems to be that of eliminating this safeguard from state securities regulation.[215]

Moreover, standards of fairness to prevent inequitable arrangements in multi-securities structures have been successfully imposed at the federal level under section 7(c) of the Public Utility Holding Company Act[216] and section 18 of the Investment Companies Act.[217] The stock exchanges view "with disfavor" the listing of non-

[210] Old Dominion Copper Mining and Smelting Company v. Lewisohn, 210 U.S. 206 (1908). Again, this is a regression from UNIFORM SALE OF SECURITIES ACT OF 1930, § 14, 9 U.L.A. 649 (1942).

[211] There may be some indirect sanctions. See Statement of Professor Loss, NAT'L ASS'N OF SECURITIES ADM'RS, PROCEEDINGS 75 (1956).

[212] See Guttman v. Illinois Central R. Co., 189 F.2d 927, 937 (2d Cir. 1951), *cert. denied,* 342 U.S. 867 (1951) (Frank, Cir. J., suggesting "prophylactic administration action").

[213] *Cf.* Galdi v. Caribbean Sugar Co., 327 Mass. 402, 99 N.E.2d 69 (1951).

[214] See BENJAMIN GRAHAM AND DAVID L. DODD, SECURITY ANALYSIS 311 (3d ed. 1951).

[215] See LOUIS LOSS AND EDWARD COWETT, BLUE SKY LAW 283, 284, 327, 328 (1958).

[216] 49 STAT. 815 (1935), 15 U.S.C. § 77g(c) (1952). See Leary, *Voting Rights in Preferred Stock Issues Under the Public Utility Holding Company Act of 1935,* 27 TEX. L. REV. 749 (1949); LOUIS LOSS, SECURITIES REGULATION 263 (1951).

[217] 54 STAT. 817 (1940), 15 U.S.C. § 80a-18 (1952). See LOUIS LOSS, SECURITIES REGULATION 100 (1951).

voting common stocks or nonvoting preferreds which do not contain adequate contingent voting clauses.[218] Under these circumstances, it is difficult to understand why it was determined to deny to a state securities administrator a similar discretion with respect to offerings of securities.

(2) *Exemptions.* In this respect, the new Act follows closely the pattern of previous attempts at uniformity. Among the exempt securities are all those listed on the New York, American, and Midwest stock exchanges, as well as any other security of the same issuer which is of senior or equal rank.[219]

Only "offers" and "sales" of unregistered securities (as distinguished from "issues") are forbidden.[220] Moreover, the Act enacts the "no-sale" theory, reached by administrative interpretation under the Federal Securities Act of 1933, by specifically excluding from the definition of "offer" and "sale" stock dividends and any act incident to a "class vote by stockholders" pursuant to a charter amendment, reclassification of securities, merger, consolidation, or sale of assets for stock.[221] Although the draftsmen of the Model Act took the position that a general corporation statute should "enable" and that any "policing must be left to blue-sky statutes,"[222] the draftsmen of the Uniform Securities Act now argue that[223]

> this area sufficiently impinges upon the corporation law and other general law of the states so that it seems better not to disturb whatever jurisprudence now applies by subjecting these corporate events to the special statutory sanctions and remedies afforded by the blue sky law.

These fundamental changes are, thus, to be free of administrative regulation at both the state and the federal level.[224]

[218] See Statement of Listing Requirements as to Preferred Stock Voting Rights, N.Y. Stock Exchange, May 4, 1940; Policy of Committee on Listing re Voting Rights, American Stock Exchange, Nov. 12, 1946. The London Stock Exchange has recently taken the position that "ordinary shares carrying no voting rights should not be regarded with favor." 107 L.J. 561 (1957); see Mears, *Nonvoting Ordinary Shares,* 1 J. BUS. L. 251 (1957).

[219] UNIFORM SECURITIES ACT—1956, § 402(8). *Cf.* UNIFORM SALES OF SECURITIES ACT OF 1930, § 4(f), 9 U.L.A. 632 (1942); UNIFORM SECURITIES ACT § 3-1(6) (tentative draft 1953).

[220] UNIFORM SECURITIES ACT—1956, §§ 301, 401(j).

[221] *Id.* § 401(j)(6)(C). The drafting of the new Uniform Securities Act is almost flawless, but a problem is posed by the "class vote" limitation where more than one class of shares is outstanding. Under DEL. CODE ANN. tit. 8, § 251 (1953), on a merger in a two-class situation, a class vote is not mandatory, unless the certificate of incorporation so stipulates. If a class vote were not required, would the exchange of securities constitute a "sale" under section 401? *Compare* the draftmen's commentary, LOUIS LOSS AND EDWARD COWETT, A PROPOSED UNIFORM SECURITIES ACT—FINAL DRAFT AND COMMENTARY 104 (1956), with LOUIS LOSS AND EDWARD COWETT, BLUE SKY LAW 347 (1958).

[222] See text accompanying note 31 *supra.*

[223] LOUIS LOSS AND EDWARD COWETT, BLUE SKY LAW 347 (1958). For the impact of the "no-sale" theory on investor protection under the Federal Securities Act of 1933, see Sargent, *A Review of the "No-Sale" Theory of Rule 133,* 13 BUSINESS LAWYER 78 (1957); Purcell, *A Consideration of the No-Sale Theory under the Securities Act of 1933,* 24 BROOKLYN L. REV. 254 (1958).

[224] The voluminous literature discussing the failure of the courts to curb what Professor E. Merrick Dodd has called the "recapitalization racket" need not be collected here. After careful study, Professor Dodd favored administrative over judicial supervision. Dodd, *Fair and Equitable Recapitalizations,* 55 HARV. L. REV. 780, 805, 816 (1942); see also Orschel, *supra* note 132, at 218. Two courts have proposed this alternative: Sherman v. Pepin Pickling Co., 230 Minn. 87, 41 N.W.2d 571 (1950); McNulty v. W. & J. Sloane, 184 Misc. 835, 54 N.Y.S.2d 253 (Sup. Ct. 1945). The SEC made a detailed study

In addition to these compulsory exchanges, the new Act exempts offers to existing security holders of the issuer if no commission or other remuneration (other than a standby commission) is paid for soliciting security holders.[225] Accordingly, most "voluntary recapitalizations" are, thus, exempted from administrative supervision.

The "isolated sale" problem is solved by exempting any transaction pursuant to an offer directed to not more than ten persons (except institutional investors) during a twelve-month period, if the seller reasonably believes that the buyers are purchasing for investment and no commission is paid for soliciting prospects. The administrator may, by rule or order, withdraw or further condition the exemption or increase or decrease the number of offerees permitted. This broad discretion would appear to permit him either to operate under the ten-offer rule or to adopt a closed-permit procedure, such as that now found in California, or to take some middle course.[226]

In general, in its basic structure, the new Uniform Act is an updated version of the 1930 Act and of the 1953 tentative draft. The most important innovations are the new coordination procedure and the effort to control promoters' and bankers' profits. The Act, however, is not one act, but three acts representing ascending degrees of securities regulation—up to a point. What is conspicuously lacking is a fourth act giving representation to the views of those states which have chosen to make a more serious attempt to control the sale of securities.[227] The failure to give the same deference to the policies expressed in the statutes of these states as to the statutes of the states with lax blue-sky laws undoubtedly is the basis for the dissatisfaction leading to a withdrawal of approval given the new Act by the North American Securities Administrators.[228]

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of the problem and suggested remedial legislation. SEC, *op. cit. supra* note 133, pt 7. The following states exercise some administrative supervision over voluntary reorganizations, mergers, and consolidations: California, Indiana, Oregon, West Virginia, and Wisconsin. And see Cowett, *Reorganizations, Consolidations, Mergers and Related Corporate Events*, 13 BUSINESS LAWYER 418 (1958).

For administrative supervision by the Interstate Commerce Commission of the modification of railroad securities under section 20b of the Interstate Commerce Act, 62 STAT. 163 (1948), 49 U.S.C. § 20b (1952), see Hand and Cummings, *Consensual Securities Modification*, 63 HARV. L. REV. 957 (1950); Note, *Railroad Modification Act of 1948*, 1 STAN. L. REV. 676 (1949); Comment, *Streamlined Capital Readjustment Under Section 20b of the Interstate Commerce Act*, 58 YALE L.J. 1291 (1949); Hand and Cummings, *Funding Arrearages Under Section 20b of the Interstate Commerce Act*, 65 HARV. L. REV. 398 (1952); Wren, *Feasibility and Fairness in Section 20b Reorganizations*, 52 COLUM. L. REV. 715 (1952).

[225] UNIFORM SECURITIES ACT—1956, § 402(b)(11). [226] *Id.* § 402(b)(9).

[227] Guesses as to the gross amount taken from fraudulent stock promotion in the United States range from $50,000,000 to $350,000,000 a year. A great part of this activity has centered in New York City. See *Fraudulent Stock Promotion: A Growth Industry?*, Fortune, Aug. 1957, p. 135; *Hearings, supra* note 90, at 473-711.

For a recent lament because some of the more financially important states "constituting excellent sales areas, have the so-called 'fair, equitable and just' blue-sky laws" and, therefore, are stifling the promotion process (listing California, Florida, Illinois, Michigan, and Texas), see Bruenner and Gilley, *Promoters, and their Profits*, 13 BUSINESS LAWYER 429, 438 (1958). No mention was made of the curious fact that these states continue to enjoy an astonishing economic growth.

[228] See note 6 *supra*. In 1956, the NASA, after commending the draftsmen for their "invaluable and outstanding contributions" to the cause of law and administration,

"RESOLVED, That insofar as may be practicable to promote uniformity in legislation, this

CONCLUSION

This is a large country, and it is to be expected that there will be strong differences of opinion, sectional and otherwise, with respect to corporation and securities legislation. In some states, securities regulation is nonexistent; in others, its administration is so weak that it might as well be abolished; while in a number of states, securities control is of a very high order. One of the virtues of our federal system is that the national government may set a minimum standard of regulation and leave to the states the opportunity to take additional measures if they so desire.[229] Too often, however, our uniform laws have constituted an amalgamation of common viewpoints in an area and a rejection of a more progressive position, with the result that the proposed statute is inadequate, if not obsolete, soon after its promulgation. This has been particularly true of uniform legislation in the corporate regulation field, and it is unfortunate since there is a wide variety of legislative and administrative experience for any state which would undertake a revision and integration of its corporation and securities laws. We should not allow our quests for uniformity to obscure past achievements or serve as barriers to further progress.

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convention assembled approve in the form presented the Uniform Securities Act, such approval being qualified further as not indicating any opinion regarding any existing state securities law or the acceptability of the Uniform Securities Act as a substitute therefor, and in no respect requiring any individual Administrator voting in the affirmative hereon to sponsor, directly or indirectly, the adoption of any such act by the Legislature of his jurisdiction." NAT'L ASS'N OF SECURITIES ADM'RS, PROCEEDINGS, 112 (1956).

A "clarifying" resolution, adopted at the 1957 convention (Ohio abstaining) reads:

"WHEREAS it has been reported in certain publications of general circulation that the North American Securities Administrators at Convention in 1956 approved the proposed Uniform Securities Act as presented to the convention by Dr. Louis Loss, and,

WHEREAS the Administrators did not approve or endorse said Act, but only endorsed the principle of uniformity in those areas in which the theories of securities laws are approximately the same; and

WHEREAS, a clarification of the position of the Administrators appears necessary and advisable,

Now, therefore, it is hereby resolved that the resolution as heretofore adopted in 1956 was intended to and did commend the drafters of the proposed Act for the laborious task that they undertook and performed but was not intended to and did not approve or recommend the Uniform Act for adoption in any state." N. AM. SECURITIES ADM'RS, PROCEEDINGS 64 (1957).

For the interpretation placed on these resolutions by the draftsmen of the Uniform Act, see LOUIS LOSS AND EDWARD COWETT, BLUE SKY LAW v, 235 (1958).

[229] See Hart, *The Relations Between State and Federal Law*, 54 COLUM. L. REV. 489, 495, 539-42 (1954); Strong, *Cooperative Federalism*, 23 IOWA L. REV. 459, 514-18 (1938).

THE ROLES OF MANAGEMENT AND SHAREHOLDERS IN CORPORATE GOVERNMENT

Frank D. Emerson*

Introduction

Following its emergence as a legal entity, the corporation rapidly has come to exhibit characteristic behavior patterns.[1] Some of these reflect its contacts with other societal institutions; some, its internal functioning. While the former have vital consequences for the law generally, they are ordinarily beyond and only indirectly affect the traditional field of corporation law. With respect to the latter, however, corporation law, and in particular the roles it defines for management and shareholders, is directly involved.

The title of this symposium suggests the thesis that corporation law today has, in a number of areas, developed a "new look." The specific questions here posed for consideration are: Is a "new look" to be found in the relative positions in which present-day statutes cast management and shareholders; and, if so, in what respects does it differ from prior modes? And more important for society generally, in so far as data have been collected, does this "new look" harmonize with current corporate behavior? Is it likely to conduce socially desirable management and shareholder behavior?

Answers to these questions may be sought by examining the provisions of contemporary corporation statutes defining the powers of management and shareholders, noting current characteristics of corporate behavior, and evaluating the former in light of the latter.

I

Law

In an effort to ascertain the nature and extent of the management-shareholder "new look" as enacted into sections of contemporary corporation statutes, it is proposed first to note the provisions applicable to management and then those relating to shareholders. While the so-called Model Business Corporation Act, as prepared, publicized, and otherwise promoted by the Committee on Corporate Laws of the American Bar Association has been critically commented upon by a number

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[1] See Adolf A. Berle, Jr., The 20th Century Capitalist Revolution (1954); Adolf A. Berle, Jr., and Gardiner C. Means, The Modern Corporation and Private Property (1932).

of persons,[2] the fact that since 1951 it has been adopted substantially *in toto* by seven jurisdictions[3] strongly suggests that it must be regarded as exemplifying contemporaneous corporation statutes.[4] For purposes of delineating and distinguishing its "new look," it may be compared with the Uniform Business Corporation Act,[5] approved nearly thirty years ago by the Commissioners on Uniform State Laws. Although the Uniform Act has been adopted by only four states,[6] this may, in large part, be attributable to the fact that the Commissioners, unlike the American Bar Association, make no active effort to obtain passage of their proposed legislation.

A. Management Provisions

The Uniform Act, like many other corporation statutes, provides that "the business of every corporation shall be managed by a board of . . . directors. . . ."[7] Similarly, the Model Act states "the business and affairs of a corporation shall be managed by a board of directors."[8] If inquiry were to cease with consideration of these provisions, the conclusion would be inescapable that thirty years have brought no "new look" to the management-shareholder sector. In fact, it could logically be observed that the very breadth and scope of these provisions make it difficult to imagine how more sweeping powers could be conferred on management. Indeed, other considerations aside, their all-inclusive language might even suggest that if any changes were to be expected, they could only take the form of limitations on management's powers. This has not been the case, however, and management powers continue to be extensive, as they always have been and as, perhaps, they always must be.

What, then, of the shareholder provisions of the Uniform and Model Acts?

B. Shareholder Provisions

Analysis of the shareholder provisions of the two acts may be approached from the standpoint of the expression they give to the traditional rights of the shareholder to elect directors and vote fundamental changes. To these there may also be added

[2] Wright, *Current Developments in Statutory Corporation Law,* 7 MIAMI L. Q 1, 6-13 (1952); Harris, *The Model Business Corporation Act—Invitation to Irresponsibility?* 50 NW. U. L. REV. 1 (1955); Dykstra, *Gaps, Ambiguities, and Pitfalls in the Utah Corporation Code,* 4 UTAH L. REV. 439, 455 (1955); Emerson, *Vital Weaknesses in the New Virginia Corporation Law and the Model Act,* 42 VA. L. REV. 489 (1956); Emerson and Latcham, *Law and the Future: Corporation Law,* 51 NW. U. L. REV. 196, 199-200 (1956).

[3] They are: Wisconsin (1951), Oregon (1953), District of Columbia (1954), Texas (1954), Virginia (1956), North Dakota (1957), and Colorado (1958).

[4] Two states recently revised and amended their corporation statutes extensively, but did not adopt the Model Act. They are: North Carolina (1957) and Ohio (1955). See Latty, Powers, and Breckenridge, *The Proposed North Carolina Business Corporation Act,* 33 N.C. L. REV. 26 (1954); Emerson, *The New Ohio General Corporation Law: Some Comments and Some Comparisons,* 24 U. CIN. L. REV. 463 (1955). The North Carolina statute is an especially excellent piece of work.

[5] 9 U.L.A. 115 (1957). This Act has since been redesignated a model act, but to obviate confusion, it will be referred to hereinafter as Uniform Business Corporation Act.

[6] They are: Louisiana (1928), Idaho (1929), Washington (1933), and Kentucky (1946). 9 U.L.A. 115 (1957).

[7] UNIFORM BUSINESS CORPORATION ACT § 31-I.

[8] MODEL BUSINESS CORPORATION ACT § 33.

the obligation of disclosure to and the right of participation by shareholders. While another traditional right of the shareholder is his right to receive dividends, it may be excluded from consideration, in light of the fact that dividends are the subject of another article in this symposium.[9]

1. *Election of directors*

Crucial here is the method by which shareholders may elect or remove directors and the nature and extent of any limitations upon their voting rights. This involves the matters of straight and cumulative voting, the frustration of cumulative voting by such devices as classification[10] and reduction in the number of directors, and the requirements for removal of directors.

The Uniform Act unqualifiedly provides for cumulative voting,[11] and renders it impossible for management to deprive shareholders of this right by means of articles or charter restrictions or otherwise. The Model Act also initially provided for mandatory cumulative voting,[12] but optional provisions for so-called permissive cumulative voting were adopted in 1955.[13] In this regard, therefore, the Model Act has a different, although hardly a "new" look, in that it alternatively contemplates only straight voting and the resultant absence of board representation for minority shareholders.

Apart from denying it by charter or articles provisions, cumulative voting may also effectively be vitiated by classification of directors and reduction of their number. The Uniform Act does not expressly recognize these techniques, but the Model Act specifically allows the former[14] and, moreover, affords no protection against the latter. It is, thus, apparent that cumulative voting not only may be denied shareholders under the Model Act, but, even where granted, may be seriously limited as a consequence of possible classification and reduction in the number of directors. These Model Act provisions, furthermore, diverge philosophically from the statutes requiring annual election of directors[15] and permitting reduction in their number, as in the case of their removal,[16] only with appropriate safeguards for cumulative voting.[17]

Although the Uniform Act provides for special meetings of shareholders,[18] it contains no provision for the removal of directors without cause, a matter of basic importance to shareholders,[19] as does the Model Act.[20]

[9] Garrett, *Capital and Surplus Under the New Corporation Statutes, infra* 239.

[10] Classification of directors is frequently referred to as the "stagger system." See LEWIS D. GILBERT, DIVIDENDS AND DEMOCRACY 189-91 (1956).

[11] UNIFORM BUSINESS CORPORATION ACT § 28-III.

[12] MODEL BUSINESS CORPORATION ACT § 31.

[13] *Id.* § 31A.

[14] *Id.* § 35.

[15] *Cf.* CAL. CORP. CODE § 805; ALA. CODE tit. 10, § 23 (1940); WYOMING COMP. STAT. ANN. § 44-109 (1945).

[16] *Cf.* OHIO REV. CODE ANN. § 1701.58(C) (Page Supp. 1956).

[17] *Cf.* MICH. COMP. LAWS § 450.13(3) (1948); N.C. GEN. STAT. 55-25(b) (Supp. 1955).

[18] UNIFORM BUSINESS CORPORATION ACT § 27-II.

[19] See HENRY W. BALLENTINE, CORPORATIONS 435 (1946).

[20] MODEL BUSINESS CORPORATION ACT § 36A.

Little that is modern, then, has been supplied by the Model Act's "new look" with respect to the election of directors. For the most part, the Model Act's sections, either directly or optionally, restrict or fail adequately to protect this basic shareholder right.

2. *Fundamental changes*

The Uniform Act affords shareholders the right to amend the articles of incorporation.[21] It also empowers them to amend the bylaws and expressly provides that director amendment of bylaws is "subject to the power of the shareholder to change or repeal such by-laws."[22] As a further shareholder safeguard, it provides, in addition, that the directors shall not make or alter any bylaw fixing their "qualifications, classification, term of office or compensation."[23]

Under the Model Act, by way of contrast, the articles or charter may be amended only if the board of directors has adopted a resolution setting forth the proposed amendment.[24] It is also expressly stated that "the power to alter, amend or repeal the by-laws or adopt new by-laws shall be vested in the board of directors unless reserved to the shareholders by the articles of incorporation."[25] Here, it is apparent that the Model Act has, indeed, a distinctly "new look," in that it imposes substantial limitations upon shareholders with respect to their traditional rights to initiate and to achieve fundamental changes and to amend the corporate bylaws.[26]

The Model Act, furthermore, substantially diminishes stockholder rights in the case of management-initiated fundamental changes. While the Uniform Act accords dissenters' rights in the event of sale, lease, or exchange of the corporation's assets, merger, consolidation, or other fundamental changes,[27] the Model Act provides merely for class voting on amendments of the articles or charter, without regard to whether they involve fundamental changes,[28] and accords dissenters' rights only in the event of a sale or mortgage of assets in the regular course of business, a merger, or a consolidation.[29]

Dissenters' rights, like charter and bylaw amendments, it is plain, receive more restrictive treatment under the Model Act than under the Uniform Act. Again, shareholder protection is sacrificed, and wider powers are given to management.

3. *Disclosure and participation*

Basic to the effective exercise of the shareholder's traditional rights respecting both election of directors and fundamental changes is his right to receive information

[21] UNIFORM BUSINESS CORPORATION ACT § 38-I.

[22] *Id.* § 26-I and II.

[23] *Id.* § 26-III.

[24] MODEL BUSINESS CORPORATION ACT § 54(a).

[25] *Id.* § 25.

[26] See Emerson, *Vital Weaknesses in the New Virginia Corporation Law*, 42 VA. L. REV. 489, 511-13, 527-28 (1956); Note, *Exclusive Control of the Adoption and Amendment of By-Laws or Regulations by the Corporate Directors*, 25 U. CIN. L. REV. 362 (1956).

[27] UNIFORM BUSINESS CORPORATION ACT §§ 42, 48.

[28] MODEL BUSINESS CORPORATION ACT § 55; see also Emerson, *Vital Weaknesses in the New Virginia Corporation Law*, 42 VA. L. REV. 489 (1956).

[29] MODEL BUSINESS CORPORATION ACT §§ 71, 74.

and to participate in corporation affairs. Disclosure and participation are also matters of importance in connection with submission of shareholder proposals,[30] the conduct of proxy contests,[31] and the prosecution of derivative suits. These matters may be viewed in the context of the provisions for inspection of books and records, availability of shareholder voting lists, and dissemination of financial statements.[32]

The Uniform Act gives to every shareholder a substantially unencumbered right "to examine, in person or by agent or attorney, at any reasonable time or times, for any reasonable purpose, the share register, books of account and records of the proceedings of the shareholders and directors and to make extracts therefrom."[33] The Model Act contrasts sharply, in that it provides, as do the statutes of a few states, that a shareholder to be entitled to inspect must have been a holder "of record for at least 6 months immediately preceding his demand or . . . the holder of record of at least 5% of all the outstanding shares."[34] Moreover, while the Model Act provides that a voting list shall be made available to shareholders,[35] the ten-day limit on availability is so short as to render meaningless the original intention of the voting-list statutes—namely, to facilitate communication among shareholders.[36]

The Uniform Act provides for the filing of annual reports with "adequate information as to the financial condition of the corporations."[37] The Model Act requires the mailing to shareholders, on written request, of the corporation's "most recent financial statements showing in reasonable detail its assets and liabilities and the results of its operations."[38] To the extent that the Model Act's section requires dissemination of financial statements, it represents a noticeable advance over the Uniform Act. Both acts, however, are extremely vague as to such matters as the management's time limit for furnishing shareholders financial statements, as well as to the form and content of those provided.

In summary, therefore, the Model Act seriously abridges the shareholder's inspection rights, is quite outdated in its voting-list availability provisions, and is both vague and inadequate with respect to the furnishing of financial information. As has already been pointed out, the "new look" in the Model Act also limits

[30] See Ledes, Emerson, Freeman, Gilbert, Bayne, and Slavin, *Proper Subject: A Symposium*, 34 U. DET. L. J. 517 (1957).

[31] See Bayne and Emerson, *The Virginia-Carolina Chemical Corporation Proxy Contest: A Case Study of the SEC's New Rule 240.14a-11 and Schedule 14B*, 57 COLUM. L. REV. 801 (1957); FRANK D. EMERSON AND FRANKLIN C. LATCHAM, SHAREHOLDER DEMOCRACY: A BROADER OUTLOOK FOR CORPORATIONS 51-70 (1954) (concerning the Sparks-Withington proxy contest).

[32] For a comparative analysis of the law in England, Canada, South Africa, France, and Brazil respecting these matters, see Emerson, *The Comparative Position of the Minority Shareholder in Selected Countries*, 3 How. L.J. 86 (1957).

[33] UNIFORM BUSINESS CORPORATION ACT § 35-IV.

[34] MODEL BUSINESS CORPORATION ACT § 46.

[35] *Id.* § 29.

[36] See Magill v. North American Refractories Co., 128 A.2d 233 (Del. Sup. Ct. 1956), 129 A.2d 411 (Del. Sup. Ct. 1957); Note, *Shareholder Voting List Statutes—Are They Effective?*, 26 U. CIN. L. REV. 288 (1957); and Emerson, *Vital Weaknesses in the New Virginia Corporation Law*, 42 VA. L. REV. 489, 513 (1956).

[37] UNIFORM BUSINESS CORPORATION ACT § 36.

[38] MODEL BUSINESS CORPORATION ACT § 46.

the shareholder's right to elect directors, restricts or eliminates his rights in connection with fundamental changes, and impairs his right to amend the bylaws. These developments would suggest that corporate behavior conforms to requisite high standards and that safeguards and limitations on managerial powers are not needed. It remains to inquire into whether, in fact, this is so.

II

BEHAVIOR

Several recent studies have concerned themselves with corporate officers, junior executives, and corporate power and its philosophical implications. Their observations, insights, and distilled conclusions, therefore, may, perhaps, afford a valid basis for evaluating the emerging statutory treatment of management-shareholder relationships.

A. Corporate Officers

The Big Business Executive[39] is an interesting starting point, for it presents a composite profile, drawn from a survey, of the chief executive of the business corporations. Typically, while still relatively young and inexperienced, he obtained a minor position with the corporation. Gradually, he worked up, through operations or production, to a vice-presidency, from which he was promoted to the presidency at the age of fifty-two. Although he has specialized professional training, he has never practiced independently, nor has he at any time run a business of his own, as his father did. He is a business administrator—a bureaucrat—with little job experience outside his own corporation. His investment in his company is nominal, usually less than .1 per cent of the outstanding stock. He is sixty-one years of age and will probably be seventy when he retires.

Professor Newcomer feels that this profile differs in at least three respects from the ideal.[40] First, the president is usually named from among the corporation's officers, probably without sufficient consideration of possibly better talent available elsewhere. Secondly, the chief executive is a specialist in engineering, law, or perhaps some other field not directly related to his job of administration. Thirdly, he is not appointed until he has reached an age too old to permit an extended period of administration prior to retirement. Professor Newcomer also finds evidence that these shortcomings may be matters of importance in the circumstance that the qualifications of executives of fast-growing companies came closer to the ideal than those of slow-growing companies.

Findings of another survey are generally similar. In *Big Business Leaders in America,* it is stated that "the typical career pattern is a bureaucratic one in business today, just as the typical business organization is primarily bureaucratic."[41] Careers, it is said, are built largely on formal education, acquisition of management skills

[39] MABEL NEWCOMER, THE BIG BUSINESS EXECUTIVE 149-50 (1955).
[40] *Ibid.*
[41] WILLIAM L. WARNER AND JAMES C. ABEGGLEN, BIG BUSINESS LEADERS IN AMERICA 215-16 (1955).

in the white-collar hierarchy, and movement through the far-flung systems of technicians and lower-level management personnel into top management.

Another writer draws some additional conclusions of an obviously provocative character. In *The Power Elite,* a Columbia University sociology professor asserts that corporate chief executives and other members of the power elite of America have no ideology, feel the need of none, rule "naked of ideas," and "manipulate without attempted justification." "It is this mindlessness," the reader is told, "that is the true higher immorality of our time; for, with it, there is associated the organized irresponsibility that is today the most important characteristic of the American system of corporate power."[42]

B. Junior Executives

Behavior data relating to the junior executive is also pertinent. On the basis of the surveys already referred to, a corporation's junior executives of today provide its chief executive of tomorrow. And in the meantime, they have an opportunity to participate in corporate decision-making and policy-formation.

The corporate junior executive, with other employees of large organizations, was examined in considerable detail in *The Organization Man*. He emerges there as overly imbued with an attitude of cooperation and little disposition to critical analysis. He is seen as "denying that there is—or should be—a conflict between the individual and organization," and this is regarded by the author as both "bad for the organization," and "worse for the individual," because "in soothing him," it "robs him of the intellectual armor he so badly needs." Fault is also found with the "denial that there is a conflict between the individual and society," for, as the author points out, "it is the price of being an individual that he must face these conflicts," and "in seeking an ethic that offers a spurious peace of mind . . . does he tyrannize himself."[43]

C. Power and Responsibility

Two other recent volumes deal in particular with the issues of power and responsibility in the corporate world. In one, *Power and Morality in a Business Society,*[44] the authors, having disposed of conscience alone as a solvent,[45] argue for a taming of power by resort to reason and human association. In developing their theme, particularly in articulating the concept of human association, the authors call for participation by "small, independent groups," even if they tend to be "self-centered and oblivious to the larger good of the community." They serve, it is asserted, a social good, principally in three ways: (1) retarding resort to technical

[42] CHARLES W. MILLS, THE POWER ELITE 342 (1956).
[43] WILLIAM H. WHYTE, JR., THE ORGANIZATION MAN 14-15 (1956).
[44] SYLVIA K. SELEKMAN AND BENJAMIN M. SELEKMAN, POWER AND MORALITY IN A BUSINESS SOCIETY 99, 129, 134 (1956).
[45] See also ADOLF A. BERLE, JR., THE 20TH CENTURY CAPITALIST REVOLUTION 61-115 (1954); Emerson and Latcham, *Law and the Future: Corporation Law,* 51 NW. U. L. REV. 196 204-05 (1956); SELEKMAN AND SELEKMAN, *op. cit. supra* note 44, at 93-96; WALTON H. HAMILTON, THE POLITICS OF INDUSTRY 137-42 (1957).

decisions by their concern for efficiency, costs, and profits; (2) restraining authority and forestalling capricious and arbitrary supervision; and (3) deterring power drives of individuals who might exploit for selfish purposes.

The Politics of Industry, the most recent of the several publications referred to, follows a description of the actual modes of power and behavior in modern society, with a concluding chapter summing up the contributions of conscience, commission, and competition as levers operating upon the exercise of power. The author finds that, while today's economy invites regulation, it is imperative that "the minority be allowed to have its chance, and that there be a thousand points in the larger system at which creative thought and effort may be applied."[46]

CONCLUSION

Contemporary corporation statutes, as exemplified by the Model Act, do not, it is submitted, accord with the realities and needs of our society. At a time when management power is widely regarded as becoming increasingly dominant, the Model Act is substantially restricting the rights of shareholders democratically to participate in corporate affairs. The provisions of the Uniform Act, drafted nearly thirty years ago, are, in a number of respects, more nearly in harmony with the available data bearing on current corporate behavior.

[46] HAMILTON, *op. cit. supra* note 45, at 167.

CAPITAL AND SURPLUS UNDER THE NEW CORPORATION STATUTES

Ray Garrett*

Introduction

The statutory treatment of capital and surplus during the first century of general business corporation statutes in the United States produced a great deal of confusion and litigation. The principal sources of difficulty seem to have been the use of terms that were susceptible of more than one meaning and the failure to define them in a technical or legal sense. In the last half century, and particularly during the last three decades, statutory revisors have sought to bring about a more precise statement of the rights and interests of stockholders in corporate capital and surplus. Their accomplishments have been commendable and provide the thesis of this article.

In early corporation statutes, the interests of stockholders were divisible into two categories—capital and surplus. The capital of a corporation was the amount that the proprietors agreed to invest in the enterprise and was measured by the aggregate par value of the shares of stock issued or susbcribed for. The courts soon imposed on this statutory concept the trust-fund doctrine, which regarded assets equal to the amount of capital as a trust fund for the protection of creditors. Whenever the assets were less than that amount, the proprietors were not entitled to make distributions to themselves; but whenever the assets exceeded that amount, the excess was regarded as surplus and was freely distributable to the proprietors, because it was necessarily derived from profits of the business. Since no particular assets were earmarked for creditors and there was no actual fund, the doctrine was nothing more than a restriction on the amount of assets that could lawfully be distributed to the proprietors.[1] This was accepted as a rule of law, with statutory tolerance, for nearly a century.

The first serious effort to define capital in a legal sense and settle the controversy over the meaning of the term began with the introduction of shares without par value in 1912. The aggregate par value of the outstanding shares was no longer the sole measure of capital, and capital represented by shares without par value could be expressed in dollars only in terms of the consideration received for them by the corporation. The later recognition of the right of a corporation to allocate only

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[1] Ballantine and Hills aptly described the situation in their reference to "the misty metaphors of the so-called 'trust fund doctrine.'" See Ballantine and Hills, *Corporate Capital and Restrictions Upon Dividends Under Modern Corporation Laws*, 23 Calif. L. Rev. 229, 230 (1935).

a portion of the consideration for no par value shares to capital created a need for a third category to represent the interests of stockholders. Surplus was no longer derived solely from profits of the business; it became a mixture of profits and a portion of the consideration contributed by stockholders. To separate the mixture into its component parts, surplus was divided into capital (or paid-in) surplus, representing a portion of the consideration received for no par value shares not allocated to capital, and earned surplus, representing profits. This occasioned the adoption of new terminology and refinements in the definition and use of the new terms. New rules were required for regulating the rights of stockholders in the three categories.

In addition, the concept of capital itself grew complex by innovations in the kinds and characteristics of capital stock that could be created. The authorized capital stock became divisible into classes and into series within a class having varying rights and preferences and having either par value or no par value. Various classes could be redeemed, converted, exchanged, or reclassified, and debt obligations could be converted into shares of capital stock. Dividends could be paid in cash, property, or shares of capital stock of the corporation. A corporation could purchase its own stock for retirement or resale. These and many other innovations required statutory recognition. A few states seized the opportunity to meet these innovations by liberalizing their laws and inviting enterprises to incorporate in their states. A competitive era ensued during which liberality was openly advertised in bids for new corporations, without regard for the locale of the business to be carried on.

The competitive era aroused the attention of other states and caused many of them to examine the limitations and restrictions of their own laws. Some states sought to modernize their laws by piecemeal amendments of existing statutes, but the results were seldom satisfactory and eventually led to complete revisions. Beginning with Ohio, which enacted an entirely new type of corporation statute in 1927, twenty-four states and the District of Columbia have completely revised their general business corporation statutes.[2] The past thirty years, then, has been an era of modernization. The motives behind modernization have been the same in every instance—to offset the competition offered by other states by eliminating obsolete provisions of earlier statutes and creating a healthier climate for modern business enterprises that would prefer to incorporate locally.

During this era of modernization, the Committee on Corporate Laws of the American Bar Association, observing the need of statutory revisors for an adequate drafting guide, undertook the preparation of a Model Business Corporation Act.[3]

[2] Subsequent to the Ohio statute of 1927, revised statutes were enacted in the following jurisdictions: Louisiana (1928), Indiana, Idaho, and Tennessee (1929), Arkansas, California, Michigan, and Pennsylvania (1931), Illinois, Minnesota, and Washington (1933), Kansas (1939), Nebraska (1941), Missouri (1943), Kentucky (1946), Oklahoma (1947), Maryland and Wisconsin (1951), Oregon (1953), District of Columbia (1954), North Carolina and Texas (1955), Virginia (1956), North Dakota (1957), and Colorado (1958).

[3] COMMITTEE ON CORPORATE LAWS, AMERICAN BAR ASSOCIATION, MODEL BUSINESS CORPORATION ACT (1957) contains the most recent version.

The first complete edition was published in 1950, somewhat revised in 1953, and supplemented in 1955 and 1957. The Model Act was not proposed as a uniform law; that had been tried by the Commissioners on Uniform State Laws in 1928, without much success.[4] Neither was it regarded by its authors as reform legislation. It was conceived as an organized selection of principles found in existing statutes, with one possible exception—the introduction of certain accounting techniques in the treatment of capital and surplus designed to render these important features more precise.

Since 1950, the Model Act has been credited as the principal source of six of the new statutes—viz., the Wisconsin Business Corporation Law (1951), the Oregon Business Corporation Act (1953), the District of Columbia Business Corporation Act (1954), the Texas Business Corporation Act (1955), the Virginia Stock Corporation Act (1956), and the North Dakota Business Corporation Act (1957). It has also been an influential factor in the Maryland General Corporation Law (1951) and the North Carolina Business Corporation Act (1955), and in recent amendments pertaining to capital and surplus in the Ohio General Corporation Law (originally enacted in 1927) and the Pennsylvania Business Corporation Law (originally enacted in 1931).[5] Since the ten revisions just mentioned represent the most recent expressions of legislative treatment of capital and surplus, they have been selected as the "new statutes" for the purposes of this article.

Each of the new statutes seeks, in its own way, to clarify the statutory law relating to capital and surplus, to avoid the confusion and ambiguities of the past, and to provide standards for the guidance of corporations in matters involving the concepts of capital and surplus. These objectives are accomplished by defining certain essential terms and then using them where appropriate in the defined sense. Remembering that business corporation statutes are applicable to corporations of every conceivable size, their provisions must be general in nature and merely set forth the basic rules to be followed in any given situation. The new statutes present the rules governing capital and surplus in a more scientific and flexible manner than existed for the past century and a quarter. Perhaps they, too, will require construction and interpretation by the courts and legal writers, but no better approach has yet been found.

The terms used in the new statutes are not necessarily new to statutory law or to accounting, although many are new to these jurisdictions. In many modern

[4] The Uniform Business Corporation Act is published at 9 U.L.A. 115 (1957). Subsequent to its original adoption, the Commissioners on Uniform State Laws changed the name of the Act to "Model Business Corporation Act." It should not be confused with the Model Act referred to in the text of this article.

[5] See D.C. CODE ANN. §§ 29-901-29-956 (Supp. 1956); MD. ANN. CODE art. 23, §§ 1-127 (1951); N.C. GEN. STAT. §§ 55-1-55-175 (Supp. 1955); N.D. Laws 1957, c. 102, §§ 1-144; OHIO REV. CODE ANN. §§ 1701.01-1701.99 (Page Supp. 1956); ORE. REV. STAT. §§ 57.002-57.994 (Supp. 1955); PA. STAT. ANN. tit. 15, §§ 2852-1-2952-1202 (Supp. 1956); TEX. BUS. CORP. ACT art. 1-01-11-01 (1956); VA. CODE ANN. §§ 13.1-13.1-132 (Supp. 1956); WIS. STAT. §§ 180.01-180.97 (1955). In addition, Colorado recently adopted a new statute substantially identical with the Model Act, which does not become effective until January 1, 1959.

statutes, the controversial terms of capital, capital stock, surplus, earnings, and profits, that are found in earlier statutes, have been replaced by stated capital and various kinds of surplus. Impairment of capital has become impairment of stated capital. Insolvency and treasury shares have been expressly defined in many statutes. The term capital stock has largely disappeared in favor of the simple term "shares," although lawyers schooled in other days find this change in terminology difficult to remember on occasion.

The Model Act proposes that the interests of shareholders be identified in three categories: stated capital, capital surplus, and earned surplus. It then sets out the manner in which the amounts in these categories are to be determined and the uses that may be made of them. A series of defined terms is the key to the proposed system —"net assets," "stated capital," "surplus," earned surplus," "capital surplus," "treasury shares," and "insolvent."[6] With the exception of insolvency, the definitions of these terms can be reduced to the following mathematical formula: beginning with total assets, deduct total debts (and treasury shares if carried as an asset), and the remainder is net assets; deduct stated capital from net assets, and the remainder is surplus; deduct earned surplus from total surplus, and the remainder is capital surplus.

The theory of the Model Act is that net assets will provide for the claims of creditors ahead of shareholders; that stated capital will provide for the permanent investments of shareholders; that capital (or paid-in) surplus will represent, in the first instance, a portion of the investments of shareholders that is less permanent but subject to special protective rules; that earned surplus will represent the accumulated and undistributed profits; that upstream transfers from earned surplus to capital surplus or stated capital should be largely discretionary with the board of directors, but downstream transfers should generally require the approval of shareholders; and that the whole purpose of the formula and restrictions accompanying it is to state when and under what circumstances corporate assets can be distributed to the shareholders. All of the new statutes employ the same theory, and variations among them reflect local preferences as to details, rather than departures from basic theory.

The drafting principles followed in the new statutes merit some explanation. The statutory revisors in any jurisdiction are faced with the problem of selecting what features of existing law should be preserved in the light of judicial construction, public policy, and familiarity among members of the local bar. The prime question asked by legislators and practitioners is: How does the proposed statute change the existing law? In answering this question, the revisors must be prepared to demonstrate the value of every important proposed change. Evaluation of a proposed change depends, in large measure, on the personal views and experiences of the revisors and the degree of objectivity with which they have approached their task. Each of the new statutes, therefore, reflects a combination, and often a compromise, of local precedents, personal views, and the study of a variety of available

[6] See MODEL BUSINESS CORPORATION ACT § 2.

alternatives, among them the several drafts of the Model Act. The result has produced a customary lack of uniformity, but a growing similarity of principles.

In discussing the treatment of capital and surplus in the new statutes, the sequence of defined terms used in the Model Act will be followed. Some of the differences among the new statutes themselves are regarded as relatively unimportant and will be ignored. Owing to differences in organization of material, moreover, it is sometimes difficult to identify their differences in principle. If errors occur below, they should be attributed to the fact that all of the new statutes are foreign to the writer's own state of Illinois.

I

NET ASSETS

The term "net assets" is in common use in corporation statutes as the minimum amount of assets that must be protected against distribution among the shareholders in order to cover the claims of creditors; but few statutes have seen fit to define it, on the theory, no doubt, that its meaning is implicit.

In preparing the Model Act, the sponsoring committee believed that it would be useful to define the term and suggested the following precise definition: "'Net Assets' means the amount by which the total assets, excluding treasury shares, exceed the total debts of the corporation."[7] Obviously, total assets are related to value; but in as much as directors are entitled under the Model Act to rely in good faith on book values,[8] there was no need to specify how the assets were to be valued. If the directors do not rely on book values in good faith, then they must substitute some other value and are responsible for the value adopted by them. The Committee debated at length the choice between debts and liabilities as elements of the definition. It chose debts as the more certain term, because they are ordinarily fixed as to liability and liquidated as to amount, whereas liabilities connote something more in the way of contingencies and speculations. The term net assets as defined in the Model Act is equivalent to the balance sheet concept of net worth and includes stated capital, surplus, and surplus reserves, which are in no sense liabilities. Since net worth appears on the liability side of a balance sheet, there was some concern over the possible impression that shareholders' interests would be regarded as liabilities, when, in fact, the term net assets was intended to represent the aggregate of their interests.

The term is used in the Model Act in two connections. The board of directors is authorized to make a distribution to shareholders in partial liquidation out of stated capital or capital surplus, subject to certain restrictions, among them a provision that the distribution must not reduce the remaining net assets below the voluntary liquidation preference of preferential shares.[9] Also, no redemption or purchase of redeemable shares can be made which would reduce the net assets

[7] *Ibid.*

[8] *Id.* § 41.

[9] *Id.* § 43.

below the amount payable to the holders of shares having equal or prior rights upon involuntary dissolution.[10]

The definition in the Model Act was available to the revisors of all of the new statutes. Their reactions furnish a good illustration of the diversity of thought on a relatively simple treatment of the subject. Undoubtedly all of the revisors had the same principle in mind, but here is what happened.

Wisconsin, Oregon, Texas, and North Dakota adopted the definition and use the term in the same manner as in the Model Act.[11] Maryland does not define net assets, but uses it in restricting a corporation's right to purchase or redeem its redeemable shares or to distribute capital surplus.[12] As to the former, something called "net asset value" is allocated to the several classes of shares in the order of seniority, and the purchase price for redeemable shares must not exceed the net asset value of such shares. As to the latter, capital surplus arising from a reduction of stated capital is distributable to shareholders only if the remaining net assets equal the voluntary liquidation preferences of shares having senior rights in liquidation. The manner of determining and allocating net asset value is left to inference. Some indication is found in the term "insolvency," which is deemed to exist if the debts exceed the assets "taken at fair valuation."[13] The District of Columbia purports to define net assets, but only for the purpose of excluding treasury shares in determining the right of a corporation to purchase its own shares and to declare and pay dividends, and in determining the liability of directors.[14] Pennsylvania defines net assets as the amount by which total assets exceed total liabilities exclusive of stated capital and surplus.[15] "Assets" is defined as including all property and rights of every kind,[16] which adds little to the ordinary meaning of assets; but there is no definition of "liabilities." It is evident that the Pennsylvania revisors found it necessary to negative the idea that stated capital and surplus might be considered to be liabilities. Ohio provides no separate definition of net assets, but uses the term in defining surplus as the excess of assets over liabilities.[17] Virginia, likewise, omits the definition, but the term is used without other identification in connection with the computation of surplus and the redemption or purchase of redeemable shares.[18]

The most elaborate definition of net assets occurs in North Carolina, which substitutes liabilities for debts and defines both assets and liabilities in a unique manner.[19] The test of inclusion or exclusion of assets and liabilities is one of reference

[10] *Id.* § 60.

[11] WIS. STAT. § 180.02(9) (1955); ORE. REV. STAT. § 57.004(8) (Supp. 1955); TEX. BUS. CORP. ACT art. 1.02(10) (1956); N.D. Laws 1957, c. 102, § 2(9).

[12] MD. ANN. CODE art. 23, §§ 32(b)(1), 36(b) (1951).

[13] *Id.* § 32(c).

[14] D.C. CODE ANN. § 29-902(L) (Supp. 1956).

[15] PA. STAT. ANN. tit. 15, § 2852-2 (Supp. 1956).

[16] *Id.* § 2852-2.

[17] OHIO REV. CODE ANN. § 1701.32(A) (Page Supp. 1956).

[18] VA. CODE ANN. §§ 13.1-2(h).

[19] N.C. GEN. STAT. § 55-2(2) and (7) (Supp. 1955).

to accounting procedures. The phrase used is "in accordance with generally accepted principles of sound accounting practice," the origin of which is unknown to the writer of this article. In the area of corporate finance, a reference to generally accepted accounting principles is in common use and relates to existing standards of the accounting profession; but the addition of "sound accounting practice" qualifies the standard by the injection of a personal judgment factor. An accounting principle may be generally accepted, but regarded as unsound by individual accountants. It is axiomatic that accountants, as do lawyers, frequently disagree on both principles and practices, and directors may be obliged to decide between conflicting views at their peril. The most significant result of these definitions is the abandonment of the corporate books as to the existence of net assets. Assets and liabilities are to be determined on the basis of what should be on the books, whether or not so recorded, and directors are not exonerated if they rely on the book value of assets, even in good faith. Their exoneration depends upon the dual accounting tests of generally accepted principles and sound accounting practice.

The North Carolina statute also superimposes a "fair present value" test in lieu of net assets in connection with dividends and purchases and redemptions of shares.[20] Such transactions are prohibited if the liabilities exceed the fair present value of the assets. In case of a distribution in partial liquidation, the fair present value must be at least equal to twice the amount of liabilities. The statute is silent on how fair present value is to be determined. These limitations impose a duty on the directors to appraise asset values before such transactions can be authorized with impunity.

It is questionable whether these elaborate refinements in the North Carolina statute contribute to the improvement of statutory law or facilitate corporate practices. They appear to create many unnecessary problems of construction and application.

However the new statutes may have defined or used the term, they recognize the necessity of confining distributions to shareholders to the excess of assets over the claims of creditors. This achieves the same result sought in the early trust-fund doctrine, without the fictions of a trust or a fund. Attempts to define assets and debts or liabilities in terms of valuation are futile, because the generality of the words employed also requires definition. It seems better to leave the responsibility with the directors and rest their liability upon good faith reliance on the corporate books or the representations of public accountants or appropriate corporate officers.

II

Stated Capital

After creditors are protected by net assets, however defined or used, any excess must satisfy the first category of shareholder interests before there is any surplus. This category is stated capital—a term that came into use with the advent of shares without par value. Such shares can be expressed in dollars on the corporate books

[20] *Id.* §§ 55-50(c)(2) and 55-52(c)(2).

only by reference to the amount of consideration received for them. Thus, stated capital became the conventional term to express the aggregate of the par value of shares having a par value and the consideration received for shares having no par value. Later, stated capital was modified to exclude that part of the consideration for no par value shares that has been allocated to capital (or paid-in) surplus.

In most modern statutes, stated capital is an elaborate successor of the older term "capital" and serves a substantially similar purpose. One outstanding exception is Delaware, which has not seen fit to change its terminology, even though shares without par value and the allocation between capital and surplus have long been recognized in that state.[21] In many respects, however, stated capital in the new statutes is conceptually quite different from its predecessor. One of its chief characteristics is flexibility; it is subject to many changes that were unavailable when par value was the sole measure of capital. In the modern sense, it must reflect the basic elements of shares that have been issued with and without par value and the effect of issuing a share dividend, or the purchase or redemption of issued shares, or the conversion or exchange of issued shares, or the capitalization of surplus without the issuance of shares, or the reclassification of outstanding shares by charter amendment; also the possibility of distributing some of the assets in partial liquidation, and the possibility of effecting a reduction for other purposes by the vote or consent of shareholders—all of these with a protecting eye on the rights of preferred shares where more than one class of shares exists.

The component parts of stated capital are identified in some of the new statutes in the form of a definition; in others, as a formula for the determination of the amount. Regardless of the form, the component parts may be classified as the basic elements, authorized increases, and authorized deductions. There is a marked similarity in all of the new statutes in the principles applied to the determination and use of stated capital; but there are differences in detail that cannot adequately be discussed in a few general statements. Therefore, the subject will be broken up according to the foregoing classification of component parts.

A. Basic Elements

In all of the new statutes, as in the Model Act, the basic elements of stated capital are determined in relation to par value shares and some or all of the consideration for shares without par value.

As to par value shares, the Model Act recognizes that it would be a flagrant violation of tradition to include them in stated capital at less than par.[22] There is an obvious representation that par value symbolizes the amount invested in the corporate enterprise. Very few statutes permit the issuance of such shares at a discount, and none of the new statutes expressly does so except North Carolina.[23] Yet, all of them recognize that the issuance and sale of shares may involve expenses and com-

[21] DEL. CODE ANN. tit. 8, § 154 (1953).
[22] MODEL BUSINESS CORPORATION ACT §§ 2, 17, and 19.
[23] N.C. GEN. STAT. § 55-46(c)(1) (Supp. 1955).

pensation to someone. For that reason, they provide that the payment or allowance of reasonable expenses and compensation may be made out of the consideration received without rendering the shares not fully paid. In North Carolina, this provision is described as a discount and required to be carried in a special account, but it is not a discount in the usual meaning of the word.

All of the new statutes, as well as the Model Act, permit the sale of par value shares at a premium. It is a common occurrence in today's market for the par value to be very low in relation to the sale price. Under most of the new statutes, any excess over par becomes capital surplus (paid-in surplus in the District of Columbia). Of course, there are exceptions. Ohio requires the entire consideration to be included in stated capital, unless the incorporators, shareholders or directors have specified that only a portion thereof shall be stated capital.[24] Virginia requires the entire consideration to be stated capital, except as otherwise provided in case of conversion or exchange.[25] This provision in Virginia would seem to permit stated capital to represent less than par, although not expressly so stated. With these few exceptions, par value is both the minimum and the maximum stated capital for par value shares under the new statutes.

The situation in respect of shares without par value involves neither premium nor discount in a sense comparable to par value shares. The board of directors is generally permitted to fix the consideration for which shares without par value are to be issued, and all of it becomes stated capital, with one exception—namely, the right of directors to allocate a portion thereof to capital (or paid-in) surplus. Among the new statutes, the permissible allocation varies as to the time it must be made and the percentage that can be allocated to surplus. A time lag before allocation will allow for inventory or appraisal where the consideration is in the form of property. Prior to the 1957 supplement, the Model Act permitted an allocation of not to exceed twenty-five per cent within sixty days after issuance of the shares.[26] This suggestion was adopted in Wisconsin, Oregon, Texas, Virginia, and North Dakota.[27] In Virginia, however, the allocation may be varied by the contract of subscription. In the other new statutes, the allocation is unrestricted as to amount, but must be made at or prior to the issuance of the shares. Notwithstanding the broad authority to make such an allocation, in all of the new statutes, as well as in the Model Act, shares without par value having a liquidation preference are protected by limiting the amount that can be allocated to surplus to the excess of the consideration received over the liquidation preference of such shares. In most cases, this limitation refers to the preference in voluntary liquidation, while in others, the reference is to involuntary liquidation; the choice depends upon the personal views of the statutory revisors.

[24] OHIO REV. CODE ANN. § 1701.30(B)(1) (Page Supp. 1956).

[25] VA. CODE ANN. § 13.1-18 (Supp. 1956).

[26] *Cf.* MODEL BUSINESS CORPORATION ACT § 19.

[27] WIS. STAT. § 180.16(2) (1955); ORE. REV. STAT. § 57.111(2) (Supp. 1955). TEX. BUS. CORP. ACT art. 2.17(B) (1956); VA. CODE ANN. § 13.1-18 (Supp. 1956); N.D. Laws 1957, c. 102, § 18.

The amounts to be included in stated capital in respect of shares with or without par value are confined to issued shares, except in Maryland and North Carolina and apparently in Ohio.[28] The full agreed consideration for shares subscribed for is included in Maryland and North Carolina, even though not fully paid, and the cancellation of subscriptions automatically reduces stated capital. In Ohio, subscriptions are not expressly included, but their cancellation effects a reduction, the logic of which is not apparent. The inclusion of unpaid subscriptions seems to be a relic of early laws, where an agreement to invest in a corporation was part of its legal capital. Also, it is possible that the status of subscriptions posed a problem as to the manner in which they should be carried on the corporate books. If so, it is suggested that the payments already received are presumably among the assets of the corporation; the unpaid amounts are also assets in the form of subscriptions receivable; and the offsetting account on the liability side of the balance sheet can be shown as shares subscribed for but not issued. If the subscriptions are canceled, the receivables and the liability account can be canceled, and the payments received would more logically become surplus than stated capital, because they constitute something in the nature of a windfall to the corporation. There seems to be no compelling reason to include partially-paid subscriptions in stated capital; only issued shares should be represented in the category that reflects the permanent investments of shareholders.

The basic elements of stated capital, then, can be described as the aggregate par value of all par value shares that have been issued and the aggregate consideration received for all shares without par value that have been issued, less portions of the consideration received for shares without par value allocated to some surplus account, with the rather minor exceptions above noted in the new statutes of Maryland, North Carolina, Virginia, and Ohio.

B. Increase by Share Dividends

Perhaps the most frequent increase in stated capital accompanies the payment of a share dividend. Where the dividend is paid in authorized but unissued shares, a new issue is involved and the new shares should be reflected in stated capital in the same manner as other issued shares—*i.e.*, at par value in case the shares have a par value and at a value fixed by the board of directors in case the shares are without par value. Where the dividend is paid in treasury shares, however, a new issue may not be involved and stated capital is not necessarily increased.

Since the payment of a share dividend out of authorized but unissued shares is in lieu of a distribution of surplus in cash or property, and no other consideration is received by the corporation, surplus should be reduced by a transfer of the amount of the dividend to stated capital. All of the new statutes, as well as the Model Act,[29] require such a transfer at par or at a value fixed by the board of

[28] MD. CODE ANN. art. 23, § 2(12) (1951); N.C. GEN. STAT. § 55-47(a) (Supp. 1955); OHIO REV. CODE ANN. §§ 1701.30(A) and 1701.31(B) (Page Supp. 1956).

[29] MODEL BUSINESS CORPORATION ACT § 40.

directors, dependent upon whether payment is made in shares of par value or without par value.

Payment of a share dividend out of treasury shares should increase stated capital only if stated capital is automatically reduced by the mere reacquisition of shares; in fact, when this happens, they are not treasury shares in a technical sense. Under most of the new statutes, as in the Model Act,[30] reacquired nonredeemable shares are not automatically canceled, and while they retain the status of treasury shares, they remain as issued shares and stated capital is not reduced until they are canceled or retired. Consequently, when reissued as a share dividend, stated capital is not increased because it already reflects such shares. Differences are noted in North Carolina and Ohio.[31] North Carolina permits a distribution of treasury shares to be made, but expressly forbids it to be described as a dividend. In Ohio, stated capital is reduced when shares are reacquired and must be restored by a transfer of surplus when reissued as a share dividend. It is not clear that treasury shares can be used for the payment of a share dividend in Maryland and the District of Columbia,[32] but all of the other new statutes expressly permit it.

C. Increase Without Change in Shares

Under some circumstances, it may be desirable to increase stated capital by a transfer from surplus unaccompanied by the issuance, redemption, exchange, cancellation, or conversion of shares. A simple example would be an increase in the par value of outstanding shares by charter amendment. In order to bring stated capital into line with the increased par value, a transfer from surplus is inevitable, because no additional consideration is paid in to the corporation. Unless the charter amendment effects the increase, a resolution of the board of directors should be adequate for the purpose.

All of the new statutes, as does the Model Act,[33] make provision for an increase in this manner. The above example is not appropriate in North Carolina, however, where a transfer from surplus is limited to shares without par value.[34]

In authorizing a transfer of surplus under these provisions of the new statutes, the board of directors may designate the class of shares with respect to which stated capital is increased, except in Ohio, where a designation appears to be mandatory,[35] and in Maryland, where no mention of the matter appears. An increase in respect of a particular class may be an important step in preparation for a distribution to shareholders or other transaction requiring the maintenance of the liquidation preference of a class of par value shares, where only par value is required to be included in stated capital when the class was originally issued.

[30] *Id.* § 61.

[31] N.C. GEN. STAT. § 55-51(d) (Supp. 1955); OHIO REV. CODE ANN. §§ 1701.31(A) and 1701.33(B) (Page Supp. 1956).

[32] MD. ANN. CODE art. 23, §§ 32(g) and 37(a)(4) and (5) (1951); D.C. CODE ANN. § 29-917(c) and (d) (Supp. 1956).

[33] MODEL BUSINESS CORPORATION ACT § 19.

[34] N.C. GEN STAT. § 55-47(4) (Supp. 1955).

[35] OHIO REV. CODE ANN. §1701.30(A) and (C) (Page Supp. 1956).

D. Decrease by Cancellation of Shares

So long as stated capital represents all issued shares, any decrease of issued shares should result in a decrease of stated capital. Such a decrease can be brought about in several ways. Let us first consider a decrease by redemption or purchase of redeemable shares.

The right of a corporation to redeem its outstanding redeemable shares is as old as the right to issue such shares in the first instance. All modern corporation statutes recognize that redeemable shares can be created, and it is an incident of their creation that they can, and sometimes must, be called for redemption at stated prices, which may vary as time goes on. Conditions and restrictions are usually specified in the charter documents creating the shares, but there are legislative restrictions in all of the new statutes.

In the new statutes, restrictions on the redemption and purchase of redeemable shares are basically related to insolvency and the protection of shares of equal or senior priority; but there is considerable variation in the language used to express them. In the Model Act, for example, the protection for creditors is found in the provision that redeemable shares cannot be purchased or redeemed if the corporation is insolvent or would be rendered so by the transaction;[36] and insolvency is defined as inability to pay debts as they become due in the usual course of business.[37] In Texas, a similar idea is expressed as a condition that no reasonable ground exists for believing that the corporation will be unable to satisfy its debts and liabilities when they fall due—a belief instead of a fact.[38] The choice of language in other jurisdictions depends somewhat on the existence or absence of insolvency as a defined term.

The most common protection for other shares is that the purchase or redemption cannot be made if it would reduce net assets below the liquidation preference of shares of prior or equal classes. For this purpose, as well as for the insolvency test, assets are subject to "net asset value" in Maryland and "fair present value" in North Carolina.[39]

In a number of the new statutes, a purchase of redeemable shares is expressly limited to the current redemption price, as it should be. In Maryland, however, a purchase is limited to the lower of the current redemption price or the net asset value attributable to the class after marshaling net asset values according to the seniority of the existing classes, although an exception to the net asset value is recognized if a sinking fund or other charter provision requires otherwise.[40] In North Carolina, a purchase or redemption is not authorized unless all accrued dividends on senior classes have been paid, or, if in default, notice of the proposed transaction is given to all holders of the class by adequate publicity.[41]

[36] MODEL BUSINESS CORPORATION ACT § 60.
[37] *Id.* § 2.
[38] TEX. BUS. CORP. ACT art. 4.09(A)(2) (1956).
[39] MD. ANN. CODE art. 23, § 32(b)(1) (1951); N.C. GEN. STAT. § 55-52(e)(2) (Supp. 1955).
[40] MD. ANN. CODE art. 23, § 32(b)(1) (1951).
[41] N.C. GEN. STAT. § 55-52(f) (Supp. 1955).

The effect on stated capital of the redemption or purchase of redeemable shares is as follows under the new statutes: In Maryland and Ohio, the shares purchased or redeemed are effectively retired without further corporate action and stated capital is reduced by the amount then represented by the retired shares.[42] The same result is achieved in the District of Columbia upon the filing of an official statement if the charter provides that such shares shall be canceled and not reissued.[43] In Virginia, North Carolina, and Pennsylvania, further action by the board of directors is required to effect a retirement of the shares, and the filing of an official statement or certificate is required before stated capital is effectively reduced.[44] In the other states, as in the Model Act,[45] the redemption or purchase constitutes a cancellation or retirement of the shares, but stated capial is not reduced until an appropriate official certificate or statement is filed. These official filings give public notice to creditors and others that stated capital has been reduced in the manner stated.

Turning now to nonredeemable shares, the general right of a corporation to acquire and dispose of its own shares has developed slowly over the years. It is presently recognized in all modern statutes, but there are legislative restrictions in the new statutes that are quite varied. These restrictions commonly consist of an enumeration of the authorized purchases that are exempt from certain restrictions, protective provisions for the benefit of creditors and other shareholders, and the measure of the amount that can be devoted to the purpose.

Early criticism of the practice of a corporation purchasing its own nonredeemable shares has resulted in at least seven specific categories in which a purchase is recognized in the new statutes, as follows: (1) elimination of fractional shares; (2) collection or compromise of debts due the corporation; (3) payment to dissenters; (4) repurchase of shares from employees; (5) release or settlement of subscriptions; (6) carrying out of an agreement with shareholders; and (7) authority granted by charter or a vote of shareholders. The first category is found in all of the new statutes except in Virginia. The second and third categories are in all of the new statutes. The fourth category is found in North Carolina.[46] The remaining categories are found only in Ohio.[47] Purchases of shares in these categories are not dependent upon the existence of surplus as a source of funds.

The problem of fractional shares commonly arises in connection with share dividends, split-ups, rights to subscribe to additional shares, conversions, and exchanges. The elimination of fractions by purchase has largely been replaced in modern practice by the issuance of scrip, cash payments in lieu of fractions, or a sale of the shares represented by all of the fractions and distribution of the proceeds

[42] MD. ANN. CODE art. 23, §§ 33(a) (1951); OHIO REV. CODE ANN. § 1701.36(B) (Page Supp. 1956).

[43] D.C. CODE ANN. § 29-924(a) (Supp. 1956).

[44] VA. CODE ANN. § 13.1-63 (Supp. 1956); N.C. GEN. STAT. § 55-48(c) and (d) (Supp. 1955); PA. STAT. ANN. tit. 15, § 2852-705 (Supp. 1956).

[45] MODEL BUSINESS CORPORATION ACT § 61.

[46] N.C. GEN. STAT. § 55-52(4) (Supp. 1955).

[47] OHIO REV. CODE ANN. §§ 1701.35(A)(3), (5), (7) and (9) (Page Supp. 1956).

among those otherwise entitled thereto. The amount involved is usually too small for great concern. Sometimes debts due a corporation can be collected or compromised only by taking over the shares belonging to the debtor; if the corporation could not acquire the shares, the debts might become a total loss. Where dissenters are paid the value of their shares in cases of merger, consolidation, sale of assets, or otherwise, the shares are technically reacquired by the corporation; and the right to reacquire is commensurate with the corporation's obligation to pay. A release or settlement with subscribers as to their unpaid subscriptions results in the acquisition of the shares subscribed for only where partially-paid shares have been issued and are included in stated capital, as in Ohio;[48] in most instances, however, it would be regarded merely as a release of subscription. A repurchase of shares from employees is appropriate only where it is a condition of some share-purchase plan available to them. A repurchase of shares from shareholders obviously refers to a restricted share transfer agreement and should be recognized if enforceable against the corporation. Charter authority or approval by the requisite percentage of shareholders needs no explanation.

Protection for creditors is afforded by forbidding purchases when the corporation is insolvent or would be rendered insolvent by the transactions, or by some kindred measure of financial condition. Where insolvency is defined, as in the Model Act,[49] the use of the term is adequate, but some of the new statutes use more elaborate language, such as: when there is reasonable ground to believe that the corporation is insolvent or would be rendered insolvent or its assets are less than its debts (Texas);[50] or when there is reasonable ground to believe that the corporation will be unable to meet its obligations as they mature in the ordinary course of business (North Carolina);[51] or when the liabilities exceed the fair present value of its assets (North Carolina).[52]

Protection for other shareholders is afforded by such restrictions as these: when the aggregate liquidation preference of shares having prior or equal rights exceeds the net assets (North Carolina);[53] or when the remaining net assets would be less than the voluntary liquidation preferences of the preferred shares (Pennsylvania);[54] or when there are unpaid accrued dividends or dividend credits on preferred shares (North Carolina, but inapplicable when the purchases are exempt as above noted).[55]

Except in case of purchases described above as exempt from certain restrictions, the right to purchase and dispose of nonredeemable shares is generally accorded to corporations within amounts measured by the existing surplus. This is justified on the theory that it may be more beneficial to the shareholders for the corporation to repurchase some of its shares out of surplus, and thus increase the interests of the

[48] *Id.* § 1701.31(B).

[49] MODEL BUSINESS CORPORATION ACT § 2.

[50] TEX. BUS. CORP. ACT art. 2.03(F) (1956).

[51] N.C. GEN. STAT. § 55-52(c)(1) (Supp. 1955).

[52] *Id.* § 55-52(c)(2).

[53] *Id.* § 55-52(c)(3).

[54] PA. STAT. ANN. tit. 15, § 2852-701(F)(2) (Supp. 1956).

[55] N.C. GEN. STAT. § 55-52(e)(4) (Supp. 1955).

remaining shareholders, than to distribute the surplus or retain it in the business. In most of the new statutes, as in the Model Act,[56] earned surplus is the primary measure of the amount and is restricted so long as the reacquired shares are held in the treasury. The similar use and restriction of capital surplus is recognized in the Model Act and in several new statutes, but frequently rests upon charter authority or approval by a prescribed percentage of shareholders. In Texas, a special kind of surplus, called "reduction surplus," is also available.[57] Pennsylvania illustrates certain limited instances permitting stated capital to be so used.[58] Ohio defines and uses the term surplus as the excess of assets over liabilities plus stated capital;[59] but, instead of using surplus as the measure of the right, goes to the trouble of providing that a corporation shall not purchase its own shares if, after such purchase, its assets would be less than its liabilities plus stated capital.[60] The District of Columbia elaborately prohibits a purchase when the corporation's net assets are less than the sum of its stated capital, paid-in surplus, appreciation surplus, and any surplus arising from surrender to the corporation of any of its shares, or when by so doing its net assets would be reduced below that sum.[61]

When a corporation has purchased its own nonredeemable shares, they become treasury shares, except in Ohio, where the shares are deemed to be retired and stated capital is automatically reduced by the amount then represented by such shares.[62] Treasury shares, on the other hand, have no effect on stated capital unless and until they are canceled or retired, in which event stated capital is reduced by the amount then representing the shares. There is considerable variation in the manner of accomplishing the cancellation and reduction. Many of the new statutes, and the Model Act,[63] permit the cancellation by resolution of the board of directors, and the reduction of stated capital is effected by the official filing of a statement or certificate of reduction. Under other statutes, the official filing is not essential to the reduction.

All of the foregoing statements of rights and procedures relating to the purchase of shares and reduction of stated capital are necessarily qualified to the extent that they may be the subject of special authority and restrictions in a corporation's own charter documents.

E. Reduction by Partial Liquidation

Under some circumstances, there is no cogent reason why a corporation should be required to retain all of its assets until final liquidation and dissolution. Accordingly, the Model Act[64] and several of the new statutes permit a distribution of a portion of

[56] MODEL BUSINESS CORPORATION ACT § 5.
[57] TEX. BUS. CORP. ACT arts. 1.02(A)(14) and 2.03(D) (1956).
[58] PA. STAT. ANN. tit. 15, § 2852-701 (Supp. 1956).
[59] OHIO REV. CODE ANN. § 1701.32(A) (Page Supp. 1956).
[60] *Id.* § 1701.35(B).
[61] D.C. CODE ANN. § 29-904a (Supp. 1956).
[62] OHIO REV. CODE ANN. § 1701.31(A) (Page Supp. 1956).
[63] MODEL BUSINESS CORPORATION ACT § 62.
[64] *Id.* § 41.

the assets in cash or in kind to the shareholders in partial liquidation. It is obvious that such a distribution involves an opinion of the board of directors that it is in the best interest of the shareholders to distribute some of the assets rather than to retain them in the business. The exercise of this authority, however, should be, and is, subject to a number of safeguards. In the Model Act, the restrictions are: that the corporation is not insolvent and would not be rendered insolvent by the distribution (a protection for the benefit of creditors); that the remaining net assets are not less than than the voluntary liquidation preference of the remaining preferred shares (a protection for the benefit of the holders of other preference shares); that all accrued cumulative dividends on preference shares have been paid (a further protection for all preferred shareholders); that authority for such a distribution is contained in the charter documents or approved by the vote of at least two-thirds of each class (assuring knowledge and consent by nonparticipating shareholders); and that disclosure of the source of the distribution accompany the distribution (to negative any inference that it is a distribution of profits). Such a distribution may be made out of stated capital or capital surplus under the Model Act. Every such distribution out of stated capital obviously is a reduction thereof, and no further corporate action is essential to make it effective.

Some interesting variations occur in the new statutes. The District of Columbia does not specify either stated capital or surplus as the source of distribution, but requires a two-thirds vote of each class for every distribution, apparently even if the charter permits.[65] The distribution is limited to capital surplus in Texas, Pennsylvania, and North Carolina.[66] Texas requires a two-thirds vote of each class of shares if that portion of capital surplus known as reduction surplus is used, and requires the board of directors to find that the distribution will not injure the corporation's ability to carry on its future business, if any is contemplated. Pennsylvania requires a majority vote of shareholders within one year prior to the distribution. North Carolina requires a majority vote, a pro rata distribution to the holders of the class receiving it, and the maintenance of assets at fair value at least equal to twice the liabilities of the corporation. Most of the other safeguards of the Model Act are adopted in the new statutes recognizing distribution in partial liquidation.

Under those statutes that limit a distribution in partial liquidation to capital surplus, if there is no capital surplus in existence, it can be created by a reduction of stated capital by consent of the shareholders or by charter amendment. Otherwise, stated capital would be reduced by the distribution itself, and the class reduced would be the class to which distribution is made. This presents no problem where the class is without par value; but if par value shares are involved, a charter amendment reducing the par value seems inescapable.

[65] D.C. CODE ANN. § 29-917a (Supp. 1956).

[66] TEX. BUS. CORP. ACT art. 2.40(A)(1) and (2) (1956); PA. STAT. ANN. tit. 15, § 2852-703 (Supp. 1956); N.C. GEN. STAT. § 55-50(e) (Supp. 1955).

F. Reduction by Consent of Shareholders

As above noted, the board of directors can increase stated capital by transfer from surplus where no change of share structure is involved. Conversely, stated capital can be reduced where no share structure change is involved, but the action must be approved by the shareholders. All of the new statutes make provision for a reduction in this manner, the percentage of affirmative votes required varying from a majority of the class affected to two-thirds of each class. The filing of an official statement or certificate of reduction is always required as public notice to creditors and others of the action taken.[67] An example of reduction by consent is suggested above as a step in preparation for the distribution in partial liquidation by creating or adding to capital surplus.

G. Conversion and Exchange

The problems incident to conversion and exchange in relation to capital and surplus have given some statutory revisors much concern and have resulted in some rather elaborate refinements. Where the convertible securities are of par value and conversions into shares of equal par value are authorized, the problem is simple; but the situation grows complex where shares without par value are involved and conversion requires the payment of some additional consideration or "boot."

A conversion or exchange of shares involves an issuance of shares and may result in an increase in stated capital. The Model Act provides a logical formula for determining the amount of consideration deemed to be received for the new shares.[68] The consideration is the sum of (1) the stated capital then represented by the shares exchanged or converted; (2) that part of surplus, if any, transferred to stated capital upon the issuance of the new shares; and (3) any additional consideration paid to the corporation upon the issuance of the new shares. Shares without par value cannot be converted into par value shares, however, unless the stated capital then represented by the convertible shares is equal to the par value of the shares to be issued. In order to produce this equality, it may be necessary for the board of directors to transfer surplus to stated capital, as contemplated by clause (2) of the formula. It should be noted that the formula permits an increase, but not a decrease, in stated capital. This treatment of conversion and exchange has been adopted in all of the new statutes except Maryland, North Carolina, Ohio, and Pennsylvania.[69]

Maryland requires the price or consideration for the shares issuable on conversion to be fixed by the board of directors prior to the issuance of the convertible securities, and approval of shareholders is required under certain conditions. Provision is made for the conversion of obligations as well as shares. All shares acquired in conversion are deemed to be retired, and no proceedings are required to reduce

[67] *Cf.* MODEL BUSINESS CORPORATION ACT § 63. [68] *Id.* § 17.

[69] MD. ANN. CODE art. 23, §§ 20 and 33(a) (1951); N.C. GEN. STAT. § 55-44(h) and 55-46(e) (Supp. 1955); OHIO REV. CODE ANN. §§ 1701.21(B) and 1701.22(D) (Page Supp. 1956); PA. STAT. ANN. tit. 15, § 2852-701(D) (Supp. 1956).

stated capital by reason thereof. It seems to be an unnecessary refinement to consider that a conversion involves both a retirement of the old and issuance of the new, both decreasing and increasing stated capital, when, in reality, the new merely takes the place of the old, with possible adjustment for differences, if any.

Pennsylvania provides that shares may be acquired on conversion or exchange and that stated capital and capital surplus then represented by the shares so acquired may be applied for the purpose. The board of directors is required to cancel such shares, however, and file an official statement thereof.

In Ohio, both convertible shares and obligations may be issued, but if the par value of the shares issuable on conversion is greater than the stated capital or principal amount of the convertible securities, the corporation must have and reserve during the entire conversion period sufficient surplus solely for transfer to stated capital when and as conversions or exchanges take place. Unless convertible shares or obligations expressly provide that stated capital shall be increased or reduced, the stated capital of shares issued on conversion is the same as the shares or principal amount of obligations converted. The same principles apply to exchanges of securities.

North Carolina is similar to Ohio in many respects, but expressly forbids conversion into shares of greater par value than the face amount of obligations, or the par value of the shares converted, or the stated capital represented by shares without par value converted, unless there is a transfer from surplus to stated capital to cover the increase. The statute, then, adopts the formula of the Model Act.

In essence, any change in stated capital by reason of conversion or exchange is directly related to the basic elements above discussed. To illustrate, suppose that a twenty-five dollar par value preferred share is convertible into 2½ shares of five dollar par value common. Such a conversion, reducing the par value from twenty-five to twelve and one-half dollars, would occur only when the earnings on the common make it more attractive than the limited preferential dividend on the preferred. Under the Model Act, and the new statutes that have followed it, stated capital of the new common would equal the par value of the preferred, or double the par value of the common, in violation of the rule that par value alone is the stated capital of par value shares. Maryland is the only new statute that appears to provide for this eventuality, by treating the preferred share as retired, stated capital reduced by twenty-five dollars, and the common shares as a new issue increasing stated capital by twelve and one-half dollars.[70] The net reduction would become capital surplus (reduction surplus in Texas). Possibly the accounting treatment under the other new statutes would be the same.

H. Charter Amendment

All of the new statutes, as well as the Model Act,[71] contain liberal provisions for the reclassification of shares by charter amendment. The effect on stated capital

[70] MD. ANN. CODE art. 23, §§ 20, 33(a) and 24(a) (1951).

[71] MODEL BUSINESS CORPORATION ACT § 53.

depends on the nature of the reclassification—increase or reduction in par value, change from par value to no par value or vice versa, change of one class into another, change of preferences within a class, and others. The amendment should make provision for its impact on the stated capital then representing outstanding shares. If it does not do so, it seems to follow that the foregoing principles respecting stated capital must be applied.

To recapitulate, stated capital under the new statutes is made up of (a) the par value of issued shares having a par value; (b) the consideration received for shares without par value not allocated to surplus; (c) amounts transferred from surplus upon payment of share dividends; (d) increases attributable to conversions, exchanges, and reclassifications of shares; (e) amounts transferred from surplus without a change of shares; (f) reductions attributable to the redemption or purchase of redeemable shares and the cancellation of other reacquired shares; (g) reductions resulting from distributions in partial liquidation; and (h) reductions authorized by charter amendments or other consent of shareholders. As above noted, this summary is subject to some variations; nevertheless, it is the prevalent pattern in most of the new statutes.

The necessity for filing official statements of changes in stated capital, particularly of reductions, is recognized in virtually all modern statutes. Its main purpose is to provide public notice to creditors and others of the current status, from time to time, of the investments of the shareholders in the corporate enterprise. It may be largely ineffective for the purpose, but it satisfies the idea that the information should be available somewhere other than in the office of the corporation itself.

We turn next to surplus, its several kinds, computations, and uses.

III

SURPLUS

The concept of surplus under modern corporation statutes and practices must be viewed in the light of developments in the concept of capital and divorced from the simple doctrine of early laws that it was synonymous with profits. In present usage, it is a mixture of profits and amounts that in former years would have been capital.

In all of the new statutes, as in the Model Act,[72] two kinds of surplus are recognized—earned surplus and capital (or paid-in) surplus. Texas injects a third kind—reduction surplus, which other states include in capital surplus;[73] and Wisconsin provides for a portion of capital surplus by the title "net capital surplus."[74]

In preparing the Model Act, the American Bar Association Committee found it desirable to employ a term that would include both capital and earned surplus to avoid repetition where both were referred to in some provisions of the Act. The

[72] *Id.* § 2.
[73] TEX BUS. CORP. ACT art. 1.02(A)(14) (1956).
[74] WIS. STAT. § 180.02(13) (1955).

term "surplus" is there defined as the excess of net assets over stated capital.[75] Thus, the existence of surplus depends upon there being something left over after making full provision for creditors (net assets) and the permanent investment of shareholders (stated capital). This approach has been adopted in all of the new statutes, except in Wisconsin, Maryland, and the District of Columbia, which found it unnecessary separately to define surplus as an over-all term.

In the discussion which follows, the determination and uses of the component parts of surplus will be largely confined to the general import of the new statutes, because a detailed description of some of the variations among them would be too tedious for an article of this length. For this purpose, the subject is broken down into earned surplus, capital surplus, and dividends.

A. Earned Surplus

No term in the area of corporation law and practice has given rise to so many conflicting opinions as has the term earned surplus. Everyone seems to know what it means, until an attempt is made to define it; then, it is challenged as inaccurate, or impractical, or ambiguous, or deceptive, or otherwise deficient. The committee that prepared the Model Act believed that it could be defined and did so by describing it as the balance of net profits, income, gains, and losses from the date of incorporation, or from the latest date when a deficit was eliminated by the application of capital surplus or stated capital or otherwise, after deducting subsequent distributions to shareholders and transfers to stated capital and capital surplus to the extent made out of earned surplus.[76] This definition is intended to reflect the net cumulative balance of profits and losses historically determined. In as much as the Act exonerates directors from liability, however, when they act in good faith upon financial statements represented to them to be correct by an appropriate officer or public accountant, and consider the assets to be of their book value,[77] they can rely on the balance sheet as evidence of the historical earnings and profits if they act in good faith.

The Model Act definition was adopted after conferences with the Committee on Terminology of the American Institute of Accountants. It was recognized that the accounting profession was discarding the term "earned surplus" in favor of such terms as "retained income," "retained earnings," "accumulated earnings," or "earnings retained for use in the business." The American Bar Association Committee was of the view that "surplus" had come into disrepute among accountants because it had not been legally defined, that it could be defined by statute in an accounting sense, and that there was no substantial difference between surplus as defined in the Model Act and the substitute terms proposed by the accountants for their own use. The accountants' committee conceded that the term "earned surplus" was more appropriate in a statute; hence, its use in the Model Act.

The definition of earned surplus proposed in the Model Act has been adopted

[75] MODEL BUSINESS CORPORATION ACT § 2. [76] *Ibid.*
[77] *Id.* § 43.

in Oregon, Texas, Virginia, and North Dakota,[78] and with modifications in Wisconsin, North Carolina, and Ohio.[79] Maryland and the District of Columbia use the term, but do not specifically define it. Wisconsin excludes profits from transactions in a corporation's own shares and losses thereon charged to capital surplus. Ohio is the same, but with a slight twist in the treatment of losses on such transactions, which may be charged to earned surplus only after absorbing gains from such transactions credited to capital surplus.

Pennsylvania is the outstanding exception to the trend adopted in the other new statutes.[80] In a recent amendment, the distinction between earned surplus and capital surplus has been reversed. Capital surplus is defined in a positive sense, and the balance of surplus is earned surplus. This change in viewpoint is attributed to the alleged practical difficulty of determining earned surplus historically and the possible liability of directors for errors in the determination. Apparently, Pennsylvania prefers to determine earned surplus by deducting from assets the claims of creditors, stated capital, and capital surplus. It is extremely doubtful that statutory revisors and accountants generally will accept the idea that earned surplus is a residue of assets, instead of a cumulative balance of profits retained in the business.[81]

Under the Model Act and those new statutes that have adopted its definition, transactions in a corporation's own shares affect earned surplus, while in Wisconsin and Ohio, the primary effect is on capital surplus. The choice may be one of personal preference, but doubtlessly is based upon conservative accounting opinion that gains and losses on such transactions should be matched through capital surplus, and only net losses charged against earned surplus.

As to unrealized appreciation, some members of the American Bar Association Committee maintain that such appreciation is properly includable in earned surplus and thus available for dividends generally. Others, including the writer, believe that unrealized appreciation should be included in earned surplus, but available only for share dividends.[82]

Earned surplus is generally available for the payment of dividends in cash, property, or a corporation's own shares; for transfer to capital surplus or stated capital; and for the repurchase of shares of the corporation. There are exceptions and conditions to each use, as was previously explained above under Stated Capital or as will be explained below under Dividends, which need not be repeated at this point.

[78] ORE. REV. STAT. § 57.004(S) (Supp. 1955); TEX. BUS. CORP. ACT art. 1.02(A)(13) (1956); VA. CODE ANN. § 13.1-3(i) (Supp. 1956); N.D. Laws 1957, c. 102, § 2(12).

[79] WIS. STAT. § 180.02(11) (1955); N.C. GEN. STAT. § 55-49(d) (Supp. 1956); OHIO REV. CODE ANN. § 1701.32(A) (Page Supp. 1956).

[80] PA. STAT. ANN. tit. 15, § 2852-2 (Supp. 1956).

[81] *Compare* Seward, *Earned Surplus—Its Meaning and Use in the Model Business Corporation Act*, 38 VA. L. REV. 435 (1952), *with* Hackney, *The Financial Provisions of the Model Business Corporation Act*, 70 HARV. L. REV. 1357 (1957).

[82] See Seward, *supra* note 81, at 440, and Carrington, *Experience in Texas with the Model Business Corporation Act*, 5 UTAH L. REV. 292, 296 (1957).

B. Capital Surplus

In the Model Act, all surplus is capital surplus, unless it falls within the definition of earned surplus.[83] Capital surplus may arise from four sources: premium received on the sale of par value shares, allocation of part of the consideration received for shares without par value, reduction of stated capital, and transfer from earned surplus, all of which have been referred to above under Stated Capital.

This definition appears in all of the new statutes, except Wisconsin, Maryland, and the District of Columbia, but with additions or variations in some of them. Contributions of property to the corporation are expressly included in Ohio and Pennsylvania.[84] Appreciation surplus is included in Ohio (appreciation in the fair value of physical assets over the amount carried on the books), Pennsylvania (unrealized appreciation), and North Carolina (resulting from a good faith revaluation upon a "demonstrably adequate basis").[85] The sale of treasury shares in excess of cost or the retirement of such shares at less than stated value is capital surplus in North Carolina.[86] North Carolina also includes "paid-in surplus," which term is used in the District of Columbia in lieu of capital surplus.[87] Texas specifies that surplus resulting in a reduction of stated capital shall be "reduction surplus," a term adopted from the current California statute.[88] Maryland provides no definition, but appears to use the term in the same sense as paid-in surplus in the District of Columbia.

Wisconsin has indulged in some accounting refinements. It defines capital surplus as the excess of the sum of stated capital and the cost of treasury shares over the sum of stated capital and earned surplus. If there is a deficit in earned surplus, it must be deducted, and the remainder of capital surplus becomes "net capital surplus."[89]

Capital surplus is a more inclusive term than paid-in surplus, which implies that it is limited to part of the consideration received for issued shares. Also, capital surplus seems to be more acceptable to the accounting profession, because it bears more resemblance to capital than earnings and profits and covers a variety of surplus terms previously in use.

Capital surplus is generally available for certain limited purposes: for distributions in partial liquidation and transfers to stated capital, as previously explained, for cash or property dividends on cumulative preference shares when authorized by charter or a specified percentage of shareholders, for purchases of a corporation's own shares in some cases, and for the reduction or elimination of certain losses or

[83] MODEL BUSINESS CORPORATION ACT § 2.

[84] OHIO REV. STAT. ANN. § 1701.32(c) (Page Supp. 1956); PA. STAT. ANN. tit. 15, § 2852-2 (Supp. 1956).

[85] OHIO REV. STAT. ANN. § 1701.32(B) and (D) (Page Supp. 1956); PA. STAT. ANN. § 2852-2 (Supp. 1956); N.C. GEN. STAT. § 55-49(e) (Supp. 1955).

[86] N.C. GEN. STAT. § 55-49(f) (Supp. 1955).

[87] *Id.* § 55-49(e); *cf.* D.C. CODE ANN. § 29-902(k) (Supp. 1956).

[88] TEX. BUS. CORP. ACT art. 1.02(A)(14) (1956); *cf.* CAL. CORP. CODE § 1906.

[89] WIS. STAT. § 180.02(12) and (13) (1955).

a deficit in earned surplus. This last mentioned use is generally available only after earned surplus has been exhausted, in accordance with the conservative accounting principle of applying losses against earned surplus before anything of a capital nature can be applied. In the definition of earned surplus in the Model Act[90] and the new statutes that have adopted it, any determination of earned surplus begins with such application, because all prior accumulations have been wiped out.

C. Dividends

All of the new statutes, and the Model Act,[91] authorize the payment of dividends in cash, property, or the corporation's own shares, but there are variations in the source and conditions attached to dividends among the statutes.

Cash and property dividends are payable out of earned surplus in all of the new statutes; and in North Carolina, also out of net profits during the current or next preceding accounting period (not less than six or more than twelve months), regardless of the impairment of stated capital—or, in other words, a deficit in surplus.[92] The payment of dividends out of current profits when there is no earned surplus, although recognized in Delaware and a few other states,[93] is regarded as deceptive by the American Bar Association Committee and the revisors of most of the new statutes. It is not found in the Model Act.

The payment of cash or property dividends is restricted in a number of ways. It is elementary that dividends should not be paid contrary to charter provisions, or on any class of shares in derogation of the rights and preferences of the shares of other classes, or when the corporation is insolvent or would be rendered insolvent by the payment. Under statutes that restrict earned surplus pending cancellation or other disposition of treasury shares, dividends should be and are limited to earned surplus not so restricted. Practically all of the new statutes permit the board of directors to establish and abolish reserves, in which case dividends are also limited to the earned surplus not so reserved. A "net asset" test is sometimes applied by prohibiting a dividend that would reduce the remaining net assets below the liquidation preferences of preferred shares; but this restriction is unnecessary where the Model Act definitions have been adopted, because the maintenance of such preferences is protected in the determination of stated capital, without which there is no surplus.

Most of the new statutes recognize the status of wasting-assets corporations and permit dividends to be paid in cash or property without deduction from earned surplus of depletion and depreciation upon disclosure of the source. This is equivalent to payment out of depletion and depreciation reserves.

Share dividends are usually payable out of authorized but unissued shares, requiring a transfer from surplus to stated capital, or out of treasury shares, the latter

[90] MODEL BUSINESS CORPORATION ACT § 2. [91] *Id.* § 40.

[92] N.C. GEN. STAT. § 55-50(2) (Supp. 1955).

[93] *E.g.*, DEL. CODE ANN. tit. 8, § 170(a) (1953); CAL. CORP. CODE § 1500(b); MINN. STAT. § 301.22(3) (1953).

not to be identified as a dividend in North Carolina.[94] In several states, as in the Model Act,[95] treasury shares may be used only if they have been acquired out of surplus; and in some states, a share dividend cannot be paid on shares of another class unless authorized by the charter or the vote of a specified percentage of shares of the class in which payment is to be made. In Ohio, only a share dividend can be paid out of surplus arising from unrealized appreciation or revaluation of assets.[96] In Ohio, a share dividend payable in treasury shares requires the same transfer from surplus to stated capital as if paid in authorized but unissued shares, because stated capital is automatically reduced when the shares are reacquired.[97]

Cash or property dividends are payable out of capital surplus to a very limited degree. The most common provision is permission to pay a cash dividend in discharge of cumulative dividends on preference shares when no earned surplus is available and when insolvency neither exists nor results. Authority is usually required in the charter or by vote of a specified percentage of shares. In North Carolina, cash or property dividends are payable out of capital surplus under such circumstances, except that capital surplus paid in by one class of shares cannot be used to pay a dividend on a junior class.[98] In Virginia, the only restriction is disclosure of the source;[99] in fact, disclosure is generally required in all of the new statutes when capital surplus is used for dividend purposes.

Paid-in surplus in the District of Columbia is usable for distributions in partial liquidation and for preferential dividends with disclosure.[100] The same is true as to net capital surplus in Wisconsin, except that it is usable for preferential dividends only if there is no earned surplus.[101] Distributions in partial liquidation have been discussed above under Stated Capital.

IV

LIABILITY

The new statutes are practically uniform in holding directors liable if they assent to the payment of any dividend or the making of any distribution or the purchase of any of the corporation's own shares in violation of the provisions of the statute. Directors who thus become liable have a right of contribution against other directors who are also liable. Assent is often presumed if a director is present at a meeting where the questionable action is taken and does not dissent then or promptly thereafter.

As previously noted, the Model Act[102] and the new statutes that follow it exonerate directors if in good faith they rely on financial statements submitted by an appropriate officer of the corporation or independent accountants, and if, in like

[94] N.C. GEN. STAT. § 55-51(d) (Supp. 1955).
[95] MODEL BUSINESS CORPORATION ACT § 40.
[96] OHIO REV. STAT. ANN. § 1701.33(A) (Page Supp. 1956).
[97] *Id.* § 1701.31(A).
[98] N.C. GEN. STAT. § 55-50(a)(3) (Supp. 1955).
[99] VA. CODE ANN. § 13.1-43(a) (Supp. 1956).
[100] D.C. CODE ANN. § 29-917(b) and 29-917a(d) (Supp. 1956).
[101] WIS. STAT. § 180.38(2)(a) and 180.38(3) (1955).
[102] MODEL BUSINESS CORPORATION ACT § 43.

manner, they assume that the corporate assets are of book value. This exoneration protects directors, who usually are not the bookkeepers, from being absolute guarantors of corporate action. It is true that some statutes seek to put directors on constant inquiry as to values and liabilities far beyond the exoneration just described; but the writer regards such responsibility as a strong and needless deterrent. Good faith reliance on others governs most of our business dealings and sets a standard of conduct that facilitates rather than impedes the availability of able directors. In contrast to North Carolina, Texas allows a director the right to rely on an opinion of independent counsel[103]—a precedent the Model Act and the other new statutes have not yet adopted.

In addition to the liability of directors, many of the new statutes permit a corporation to recover any unlawful dividend or other distribution knowingly received by shareholders. This is based upon a homely principle that if a shareholder knows he should not have received the same, he should return it.

CONCLUSION

The foregoing technical review of the ten most recent revisions of business corporation statutes, as well as of the Model Act, illustrates the statutory trend in respect of capital and surplus and the many ways in which statutory revisors can vary details within the basic principles of the trend. The fundamental concepts of capital and surplus are essentially the same in all of the new statutes; the variations are in relatively minor matters, reflecting local policies, precedents, and traditions.

Uniformity among the states appeals to reason as an ultimate aim, but there is little prospect of complete uniformity in the area of corporation law in the near future. Each jurisdiction approaching a revision of its corporate statute is deeply conscious of its sovereignty and freedom of choice. In exercising this freedom, it selects from its own past and from other jurisdictions what it believes to be the best policy for the artificial beings created pursuant to its laws. Very few statutes have the attribute of originality; the draftsmen look about to see what others have done, select what they like, and impose their personal views. Then, the legislators superimpose their own ideas of policy and politics. Thus, when similarities appear, it is a tribute to the soundness of principle. Such is the case with the new statutes here reviewed. The striking thing is that they are so nearly alike, not that they are so different, when the drafting and legislative processes are considered.

In the deliberate way in which our state governments are accustomed to proceed, there may yet appear a larger degree of uniformity than previously known in expressing the statutory law affecting the rights of shareholders in the financial structure of modern business corporations. If the Model Act contributes to this result, it will have served its purpose exceedingly well.

[103] TEX. BUS. CORP. LAW art. 2.41(D) (1956).

SHARE CHARACTERISTICS UNDER THE NEW CORPORATION STATUTES

William D. Ford*

Introduction

Over the past thirty years, many states have substantially revised their general business corporation statutes.[1] This development has reflected a realization that previously existing statutes were unsuited to the requirements of the modern corporation and, because they were unsuitable, had induced businessmen to incorporate elsewhere and to do business as a foreign corporation in the state which, except for its obsolete laws, should have been the situs of incorporation.[2]

The manner in which these revisions have been effected has depended primarily upon the starting point taken by the committee assigned to the task in the particular state. All but two of the nine corporation statutes which have been revised since 1950 have been patterned after the Model Business Corporation Act prepared by the Committee on Corporate Laws of the American Bar Association.[3] The Maryland revision was based upon many sources, particularly its existing corporation statutes, but also the statutes of other states and the Model Act. The Ohio revision was based primarily upon the earlier corporation statutes of that state. Other states that are considering revision of their corporation statutes, however, appear to be inclining to the Model Act.[4]

Section fourteen of the Model Act provides that authorized shares may be divided into one or more classes and permits great latitude with respect to such share characteristics as voting, par value, preferences on liquidation, dividends, redemption of shares, convertibility, and pre-emptive rights. Each of the new statutes which has

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[1] See Garrett, *Model Business Corporation Act*, 4 Baylor L. Rev. 412, 416 (1952), for a list of the statutes revised during the years 1927-51. Since 1950, the following states have adopted revised general business corporation statutes: District of Columbia (1954), Maryland (1951), North Carolina (1955), North Dakota (1957), Ohio (1955), Oregon (1953), Texas (1955), Virginia (1956), and Wisconsin (1951).

[2] The North Carolina Business Corporation Act, as proposed to the Legislature, contained a provision intended to prevent avoidance of its corporation statutes by making their provisions applicable to pseudo-foreign corporations doing business in North Carolina. A pseudo-foreign corporation was defined as ". . . a foreign corporation which . . . obtains . . . a certificate of authority to transact business in this State and which engages in no substantial business activity in the state or country of its incorporation, and which, by virtue of the place and character of its business and personnel, is more closely identified with the business life of this State than with that of any other state or country. . . ." N.C. S.B. No. 49, § 55-2(11) (1955). Because of the vagueness of its language as well as its novelty, the Legislature omitted this provision in adopting the Act. See Powers, *Drafting a Corporation Code for North Carolina*, 10 Ark. L. Rev. 37, 44 (1955).

[3] The Model Business Corporation Act was first widely-publicized in Business Lawyer, Nov. 1950, No. 1. It has since been published as a handbook by the Committee on Continuing Legal Education of the American Law Institute in its 1950 form, and, with revisions, it has been republished in 1953 and 1955.

[4] See Garrett, *supra* note 1, at 425.

followed the Model Act has directly adopted section fourteen;[5] and those which have not, contain a comparable provision which affords similar leeway with respect to share characteristics.[6] This article will proceed to examine the new statutory provisions relating to the more important share characteristics.

I

VOTING

A. Generally

Under the Model Act, each outstanding share of stock is entitled to one vote on each matter submitted to a vote at a meeting of the shareholders, but voting rights may be limited or denied to any class by the articles of incorporation to the extent not prohibited by the Act.[7] Under that Act, the matters as to which voting rights cannot thus be limited or denied are mergers or consolidations;[8] sales, leases, mortgages, and other dispositions of all or substantially all assets not in the regular course of business;[9] voluntary dissolution;[10] revocation of voluntary dissolution proceedings;[11] and amendments to the articles of incorporation substantially affecting the shares of any class.[12] On all of these important matters, corporate action prerequires a two-thirds vote of all issues and outstanding shares. And in the case of an amendment to the articles of incorporation[13] or a merger or consolidation[14] substantially affecting the shares of a class, a two-thirds vote of that class is also required.

The pattern of the Model Act with respect to voting rights has been followed in each of the jurisdictions which has based its revised corporation statute thereon, but in all cases, there has been some variation. Many of these new statutes differ from the Model Act with respect to the percentage of vote required for various corporate actions.

The Texas statute requires[15] a four-fifths vote for all action requiring a two-thirds vote under the Model Act,[16] except amendments to the articles of incorporation, which require a two-thirds vote,[17] and mortgages and pledges of assets not in the regular course of business, which may be authorized by action of the board of directors.[18] Although Texas, in adopting this requirement, has merely adhered to

[5] D.C. CODE ANN. § 29-908 (Supp. 1956); N.C. GEN. STAT. § 55-40 (Supp. 1955); N.D. Laws 1957, c. 102, § 12; ORE. REV. STAT. § 57.080 (Supp. 1955); TEX. BUS. CORP. ACT, art. 2.12 (1956); VA. CODE ANN. §§ 13.1-12, 13.1-13 (Supp. 1956); WIS. STAT. § 180.12 (1955).

[6] OHIO REV. CODE ANN. § 1701.06 (Page Supp. 1956); MD. ANN. CODE art. 23, § 14 (1951).

[7] MODEL BUSINESS CORPORATION ACT §§ 14, 31.

[8] *Id.* § 67.

[9] *Id.* § 73.

[10] *Id.* § 77.

[11] *Id.* § 82.

[12] *Id.* § 53.

[13] *Id.* § 55.

[14] *Id.* § 67.

[15] For the Texas provision as to voting generally, see TEX. BUS. CORP. ACT art. 2.29 (1956).

[16] *Id.* art. 5.03 (as to merger or consolidation), *id.* art. 5.10 (as to sales, leases, exchanges, and other dispositions, other than mortgages and pledges, of all or substantially all assets), *id.* art. 6.03, 6.08 (as to dissolution and revocation of dissolution).

[17] *Id.* arts. 4.02, 4.03.

[18] *Id.* art. 5.10, as amended, Tex. Acts 1957, c. 54, § 9. As originally adopted, this provision required an eighty per cent shareholder vote for mortgages, but this was found to be too burdensome and

its prior statutory standard, such a high percentage vote would appear to be unnecessarily strict and unduly burdensome. Stockholder inertia alone in a publicly-held corporation might suffice to prevent corporate action which requires an eighty per cent affirmative vote. If it were considered desirable to retain the eighty-per-cent-approval requirement for important action, it might have been preferable to have prerequired only a two-thirds vote, while giving a veto power to votes of twenty per cent cast in opposition. At least this would have put the burden on the opposition. Since dissenters' rights are available in each case where the eighty per cent vote is required, however, even such a veto power is probably unnecessary, as the potential cash drain from dissents would in most cases serve as an effectual deterrent to an unpopular plan.

North Carolina, adhering to its pre-existing statutory standard, has reduced to a majority the vote required for a merger or consolidation[19] or an amendment of the articles of incorporation.[20] This reduction can be justified on the theory that the availability of dissenters' rights in these situations affords adequate protection to those shareholders who may feel themselves prejudiced thereby. In any case, it would seem to make little difference whether the vote requirement is two-thirds or a majority, as experience indicates that plans seldom fail because of inability to muster the statutory minimum. The real limiting factor is rather the threat to working capital posed by dissenters' rights of appraisal.

The District of Columbia statute has departed from the Model Act provision by requiring a class vote for a merger, whether or not the merger would effect a substantial change in the securities of such class.[21] This is the antithesis of the philosophy embodied in the New York[22] and Delaware[23] statutes, which do not even require a class vote where the rights of a class of shares would be substantially affected by the merger or consolidation. These latter statutes rather rely on dissenters' rights to guarantee adequate protection against changes adversely affecting a particular class.

In certain states, the requirement that all shareholders be granted a vote on a particular action has been changed to specify that only those shareholders entitled to vote under the articles of incorporation may vote. In Wisconsin[24] and the District of Columbia,[25] this has been done with respect to sales, mortgages, and pledges of all assets in other than the regular course of business. Under the Ohio statute, only shareholders entitled to vote under the articles of incorporation may vote with regard to amendments, mergers or consolidations, sales of assets, and dissolution.[26] In the same vein, North Carolina, Texas, and Virginia have eliminated the require-

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was changed by amendment in the 1957 legislative session to its present form. See Carrington, *Experience in Texas with the Model Business Corporation Act*, 5 UTAH L. REV. 292, 302 (1957).

[19] N.C. GEN. STAT. § 55-107 (Supp. 1955).

[20] *Id.* § 55-101.

[21] D.C. CODE ANN. § 29-927c (Supp. 1956).

[22] N.Y. STOCK CORP. LAW §§ 51, 86.

[23] DEL. CODE ANN. tit. 8, § 251 (1953).

[24] WIS. STAT. § 180.71 (1955).

[25] D.C. CODE ANN. § 29-928 (Supp. 1956).

[26] OHIO REV. CODE ANN. §§ 1701.06, 1701.71, 1701.76, 1701.79, 1701.86 (Page Supp. 1956).

ment of a shareholder vote in connection with mortgages or pledges of assets.[27] Since the board of directors, without shareholder action, can create other indebtedness, which, upon a default and prosecution to judgment may become a lien on the corporation's assets, there would not appear to be any real reason for otherwise inhibiting the execution of a direct mortgage or pledge of assets to secure such indebtedness.[28]

Several of the new statutes have added dissenters' rights with respect to matters where dissenters are not accorded such rights under the Model Act. The Model Act provides for the right of dissent only in connection with mergers, consolidations, and sales or exchanges of assets.[29] The North Carolina statute, however, has added dissenters' rights with respect to amendments to the certificate of incorporation which substantially affect a class of equity securities which is preferred as to dividends or on liquidation.[30] And the Ohio statute has a substantially identical provision.[31] But in so providing, these statutes impair a corporation's ability to reclassify its shares when such action is desirable or even necessary for purposes of reorganization. Thus, if a corporation seeks to reorganize by reclassifying a preferred class of its equity securities, the availability of dissenters' rights might constitute such a cash-drain potential as to prevent, as a practical matter, the effectuation of the plan.

In eliminating the right afforded by section fifty-three of the Model Act, by amendment to the articles of incorporation to cancel or otherwise affect the right of holders of shares to receive cumulative dividends which have accrued but have not been declared, the District of Columbia statute may raise a similar problem.[32] During the 1930's, many corporations sought to eliminate accrued dividend arrearages in this manner.[33] Since the existing statutes did not specifically authorize this technique, the courts held, in a number of instances, that such accrued undeclared dividends were vested rights and could not be so divested.[34] Consequently, they declared void reorganization plans which sought to reclassify shares to eliminate accrued dividends or to capitalize them by the issuance of shares in return therefor. To circumvent this obstacle, corporations subsequently resorted to mergers with wholly-owned subsidiaries, a technique that was sanctioned by the courts.[35] Statutory provisions permitting amendment of the articles of incorporation to reclassify

[27] N.C. GEN. STAT. § 55-112 (Supp. 1955); TEX. BUS. CORP. ACT art. 5.09 (1956); VA. CODE ANN. § 13.1-77 (Supp. 1956).

[28] See Carrington, *supra* note 18, at 304.

[29] MODEL BUSINESS CORPORATION ACT §§ 71, 74.

[30] N.C. GEN. STAT. § 55-101 (Supp. 1955).

[31] OHIO REV. CODE ANN. § 1701.74 (Page Supp. 1956).

[32] D.C. CODE ANN. § 29-921f (Supp. 1956).

[33] See Barnhart, *Recent Trends in Corporation Legislation*, 10 ARK. L. REV. 12, 22 (1955).

[34] *E.g.*, Keller v. Wilson, 21 Del. Ch. 391, 190 Atl. 115 (Sup. Ct. 1936); Film Industries v. Johnson, 22 Del. Ch. 407, 197 Atl. 489 (Sup. Ct. 1937). *Contra*, McNulty v. W. & J. Sloane, 184 Misc. 835, 54 N.Y.S.2d 253 (Sup. Ct. 1945).

[35] Havender v. Federal United Corp., 24 Del. Ch. 318, 11 A.2d 331 (Sup. Ct. 1940); Holtenstein v. York Ice Machinery Corp., 136 F.2d 944 (3d Cir. 1943).

shares in order to eliminate accrued dividend arrearages,[36] however, obviate this problem; but any plan of reorganization involving the elimination of such arrearages must be fair and equitable,[37] giving an equivalent in return therefor. Failure to adopt the portion of section fifty-three of the Model Act permitting such elimination of arrearages, will therefore, resurrect the problem which the Model Act had sought to cure.

The original draft of the Model Act, patterned after the Illinois statute,[38] provided that each share of stock was entitled to one vote in all matters, and the right to vote was subject to abridgment only in the case of junior stocks where preferred dividends were in arrears.[39] It was felt, however, that the Illinois statutory provision was unnecessarily stringent. Thus, it would have prevented the issuance of nonvoting preferred stocks, a fairly traditional security, and, it would have deprived the corporation of flexibility in other situations where equity financing without disturbing control is the object. For example, in the recent trend toward restricted stock option plans, closely-held corporations have sought to grant to officers and key employees the tax benefits of restricted stock option plans, without giving them a voting security. This has been done through the issuance of options on nonvoting shares. A strict statutory provision as to voting rights, such as that of Illinois, would not have permitted this. Accordingly, the Model Act was altered to its present form in 1953.

The Model Act provision restricting mandatory voting to important matters has been a real step forward in providing both flexibility and sufficient shareholder safeguards. The new statutes patterned after the Model Act apparently have found its general provisions sufficiently palatable to warrant substantial adoption. Except for the adherence by Texas to its *sui generis* high vote requirement, the inclusion of dissenters' rights upon amendments of the articles of incorporation by North Carolina, and the omission by the District of Columbia of the right to amend the articles of incorporation by a two-thirds vote to eliminate accrued dividend arrearages, the changes imported into the Model Act by the various jurisdictions that have embraced it do not appear to have disturbed its basic philosophy.

B. Cumulative Voting

The 1953 revision of the Model Act made cumulative voting for the election of directors compulsory.[40] Among the alternative provisions introduced in the 1955 revision, however, was one making cumulative voting optional.[41] The compulsory provision has not been adopted in any of the states whose new statutes are patterned after the Model Act, except North Dakota,[42] which has a constitutional

[36] *E.g.*, MD. ANN. CODE art. 23, § 10(9) (1951). [37] See Barnhart, *supra* note 33, at 24.

[38] ILL. REV. STAT. c. 32, §§ 157.14, 157.28 (1955).

[39] See Harris, *The Model Business Corporation Act—Invitation to Irresponsibility?*, 50 NW. U. L. REV. 1, 12 (1955).

[40] MODEL BUSINESS CORPORATION ACT § 31.

[41] Alternative provisions are set forth in COMMITTEE ON CORPORATE LAWS, AMERICAN BAR ASSOCIATION, MODEL BUSINESS CORPORATION ACT, REVISIONS AND OPTIONAL SECTIONS (1955).

[42] N.D. Laws 1957, c. 102, § 30.

provision requiring cumulative voting. Texas, Virginia, Oregon, and the District of Columbia provide that the articles of incorporation may permit cumulative voting.[43] In North Carolina and Ohio, cumulative voting is also permitted, but for it to apply to a particular election of directors, appropriate notice must be given by the shareholder desiring it.[44] In originally providing only the compulsory cumulative-voting provision, the draftsmen of the Act were of the opinion that minority representation should be preserved under all circumstances;[45] but after further reflection, they appear to have changed their minds and now offer the alternative provision without recommendation.[46]

In thirteen states, cumulative voting is constitutionally required; it is made mandatory by statute in six other states; and twelve states have permissive provisions with respect thereto.[47] In making cumulative voting permissive rather than mandatory, the recently-adopted statutes have conformed to the majority view of states in which the matter is not regulated by a constitutional provision.

The compulsory cumulative-voting alternative provision of the Model Act is, to some extent, modified by section thirty-five, which provides that when a board of directors consists of nine or more members, it may be divided into two or three classes, each of which may be elected on a staggered basis, so that only a portion of the whole board is elected annually. In states which constitutionally require cumulative voting, a problem will be raised as to whether or not this statutory provision may be adopted. Thus, in *Wolfson v. Avery*,[48] the court held that the Illinois statutory provision permitting the classification of directors conflicted with the constitutional requirement. In other states having this constitutional requirement, however, the question is still open, and some corporations there continue to classify their boards of directors, regardless. Until a decision is rendered in the matter in these states, such boards of directors will prove to have *de facto* rather than *de jure* status if it is finally determined that such classification is invalid. The precise wording of the constitutional requirements is not the same in each of these states, however, and it may be that the courts will distinguish the *Wolfson* case and uphold classified boards. It may be significant in this connection that in spite of its constitutional requirement of cumulative voting for directors,[49] North Dakota has adopted the Model Act provision permitting classification of directors,[50] its legislature apparently recognizing no conflict.

By limiting the classifications to only two or three and by limiting the power to

[43] TEX. BUS. CORP. ACT art. 2.29D(2) (1956); VA. CODE ANN. § 13.1-32 (Supp. 1956); ORE. REV. STAT. § 57.170(4) (Supp. 1955); D.C. CODE ANN. § 29-911 (Supp. 1956).

[44] N.C. GEN. STAT. § 55-67 (Supp. 1955); and OHIO REV. CODE ANN. § 1701.55 (Page Supp. 1956).

[45] Preface to 1950 revision at p. vi, contained in COMMITTEE ON CORPORATE LAWS, AMERICAN BAR ASSOCIATION, MODEL BUSINESS CORPORATION ACT (1953).

[46] See Carrington, *A Corporation Code for Texas*, 10 ARK. L. REV. 28, 33 (1955).

[47] See Commissioners' Note following MODEL BUSINESS CORPORATION ACT OF 1928, 9 U.L.A. 108 (1951).

[48] 6 Ill.2d 78, 126 N.E.2d 701 (1955).

[49] N.D. CONST. § 135.

[50] N.D. Laws 1957, c. 102, § 35.

classify to boards having more than nine members, the Model Act, to some extent, dampens the effect of classification. But classification, nevertheless, effectively frustrates, at least partially, the purpose of the cumulative voting requirement. For instance, if the board of directors consisted of nine and all were elected at one election, it would take ten per cent of the vote plus one vote to elect one director. If the board were classified so that only three were elected at a time, however, it would take twenty-five per cent of the vote plus one to elect one director.[51]

C. Miscellaneous Provisions Relating to Voting

Under section 136 of the Model Act, which has been adopted by each jurisdiction patterning its act after the Model Act, a greater vote may be required by the articles of incorporation with respect to particular action than is specified by the statute for such action. This provision was intended to overrule those cases which have, in certain instances, cast doubt on the validity of such articles.[52] It can prove particularly useful in meeting the needs of closely-held corporations, which may be regarded as incorporated partnerships.[53]

Section thirty-two, likewise adopted in each such jurisdiction, authorizes the creation of voting trusts limited to a ten-year period. A copy of the voting-trust agreement must be deposited with the corporation and must be open to examination by shareholders and holders of an interest in the voting-trust agreement at all times.

Certain other provisions of the Model Act, fixing the voting status of particular persons in specified instances and the manner in which voting may be conducted, have also been adopted by the jurisdictions following the Model Act.[54] These provisions make it clear that treasury shares are not entitled to vote; that voting may be accomplished by proxy, but proxies are not valid after eleven months, unless otherwise provided in the proxy; that shares held by the corporation in another corporation may be voted, specifying the person who may vote them on behalf of the corporation; and that the pledgor votes pledged shares until they are transferred into the name of the pledgee. They also cover the voting status of fiduciaries and trustees. Other provisions relate to notice requirements, record dates, closing the transfer books, quorum requirements, and taking action by unanimous written consent instead of voting at meetings. By clarifying procedures and voting status, those provisions eliminate uncertainties which experience has shown would otherwise exist.

II

PRE-EMPTIVE RIGHTS

The Model Act provides that the pre-emptive right of a shareholder to acquire unissued or treasury shares may be limited or denied to the extent provided in the

[51] See Note, 50 NW. U. L. REV. 112 (1955); CHARLES M. WILLIAMS, CUMULATIVE VOTING FOR DIRECTORS 48 (1951).

[52] Jones v. St. Louis Structural Steel Company, 267 Ill. App. 576 (1949).

[53] See Latty, *The Closed Corporation and the New North Carolina Business Act*, 34 N.C.L. REV. 432, 444 (1956).

[54] MODEL BUSINESS CORPORATION ACT §§ 27, 28, 30, 31, 138.

articles of incorporation. If the articles do not originally so provide, the corporation, by amendment procedures, including a class vote by the class or classes of shares having pre-emptive rights, may amend its articles of incorporation to limit, deny, or grant such pre-emptive rights.[55] Unless otherwise provided in the articles of incorporation, any corporation may sell its shares to its officers or employees or to officers or employees of any subsidiary, without first offering such shares to its shareholders, if the terms of the option are approved by the holders of two-thirds of each class of shares entitled to vote thereon or by its board of directors pursuant to like approval of shareholders. The Model Act does not define the term "pre-emptive rights," but leaves it to the common law. It does, however, specify that pre-emptive rights apply to treasury shares, although this is not true at common law.

These provisions have been adopted almost verbatim in North Dakota,[56] Oregon,[57] Texas,[58] and the District of Columbia.[59] The District of Columbia, however, has deleted the reference to treasury shares. Wisconsin did not adopt the provision for the limitation of pre-emptive rights in connection with sales of shares to employees.[60]

The states of Virginia and North Carolina also have departed in a substantial way from the Model Act provisions in defining pre-emptive rights and the particular situations in which they are applicable. The Virginia statute limits these rights to unissued shares and clarifies their status in certain other contexts. Thus, pre-emptive rights do not apply to shares issued for services or property or to shares issued to officers or employees pursuant to a plan approved by the shareholders; the holders of shares preferred as to dividends and assets are not entitled to pre-emptive rights for shares of any class; the holders of common stock are not entitled to pre-emptive rights as to shares preferred and limited as to dividends or assets; and the holders of nonvoting common stock are not entitled to pre-emptive rights as to common stock. The articles of incorporation may, however, confer pre-emptive rights where not provided by the statute. And if a package is offered consisting of common stock and other securities, it is not contemplated that pre-emptive rights will apply.[61]

Under the North Carolina statute, pre-emptive rights apply to treasury shares, but, as is also the case under the Virginia statute, they are otherwise limited to circumstances under which they would be available at common law.[62] The North Carolina provision relating to pre-emptive rights was based on the comparable Ohio statute[63] and resembles it particularly in that it provides a definition of pre-emptive rights and covers pre-emptive rights with respect to convertible securities and options.

[55] *Id.* §§ 24, 53, 55. Alternative provision is set forth in COMMITTEE ON CORPORATE LAWS, AMERICAN BAR ASSOCIATION, MODEL BUSINESS CORPORATION ACT, REVISIONS AND OPTIONAL SECTIONS (1955).

[56] N.D. Laws 1957, c. 102, §§ 23, 54.

[57] ORE. REV. STAT. §§ 57.136, 57.355, 57.365 (Supp. 1955).

[58] TEX. BUS. CORP. ACT arts 2.22, 4.02, 4.03 (1956).

[59] D.C. CODE ANN. §§ 29-908; 29-921f, 29-922 (Supp. 1956).

[60] WIS. STAT. §§ 180.21, 180.50 (1955).

[61] VA. CODE ANN. § 13.1-23 (Supp. 1956), and comment thereon of the Code Commission appointed to draft the statute.

[62] N.C. GEN. STAT. § 55-56 (Supp. 1955).

[63] OHIO REV. CODE ANN. §§ 1701.15, 1701.22 (Page Supp. 1956).

Under the North Carolina and Ohio statutes, it is expressly provided that pre-emptive rights do not apply to shares issued to satisfy conversion or option rights, but the issuance of securities convertible into shares or options to purchase shares of a class which has pre-emptive rights requires approval by a two-thirds vote of that class, which vote operates as a waiver of its pre-emptive rights.[64] On the other hand, under the New York Stock Corporation Law, it is expressly provided that convertible securities and options are subject to pre-emptive rights and that these rights may be satisfied by first offering the convertible security or option to stockholders.[65] At common law in some jurisdictions, too, pre-emptive rights apply to convertible securities[66] and may be satisfied by giving existing shareholders having such rights the right of first refusal with respect thereto prior to their issuance. Apparently the Model Act leaves the resolution of these matters to the common law.

During recent years, convertible debentures have become a popular method of financing. Also, in connection with underwritings, particularly in the case of small corporations, options have been granted in lieu of cash payment to underwriters. It would seem, therefore, that to the extent that these new statutes have clarified the status of pre-emptive rights with respect to convertible securities and stock options, they have effected a significant improvement.

The North Carolina and Ohio statutes also specifically provide for the waiver of pre-emptive rights in particular cases by two-thirds vote.[67] The Model Act, by expressly referring to waiver in the case of employee stock-option plans, gives rise to the implication that waiver in other instances by a specified vote is not possible, unless otherwise authorized by the articles of incorporation. Of course, a procedure which could be followed under the Model Act would be to amend the articles of incorporation so as to provide for the limitation of pre-emptive rights in particular instances by a specified vote of shareholders, and to obtain a vote for limitation with respect to a particular issue involved.

It is understood that the draftsmen intend to revise the provisions of the Model Act with respect to pre-emptive rights. In so doing, they may follow the North Carolina statute in defining what is meant by pre-emptive rights. With respect to options and convertible securities, they may follow the North Carolina and Ohio statutory provisions, which deny pre-emptive rights in connection therewith, or the New York statutory provision, which recognizes these rights and specifies the means of satisfying them.

[64] N.C. GEN. STAT. §§ 55-44, 55-56 (Supp. 1955); OHIO REV. CODE ANN. §§ 1701.15(D) and (E), 1701.16, 1701.22 (Page Supp. 1956).

[65] N.Y. STOCK CORP. LAW § 39.

[66] See HENRY W. BALLENTINE, CORPORATIONS 491 (1946).

[67] N.C. GEN. STAT. § 55-56(c)(6) (Supp. 1955); OHIO REV. CODE ANN. § 1701.15 (Page Supp. 1956).

III

PAR VALUE

Under the Model Act, corporations have complete freedom of action in determining whether shares will have par value or not and if so, how much par value will be.[68] In addition, by amendment, which requires a class vote, there is complete freedom to increase or decrease par value, or to change from par to no par value, or vice versa.[69] The concept of par value affects the stated capital and capital surplus of the corporation, both of which are defined terms under the Model Act.[70] Shares having a par value may not be issued for a lesser consideration, which, to that extent, becomes stated capital of the corporation; the excess, if any, over par value becomes capital surplus, which the board of directors is free to transfer wholly or partially to stated capital, as it wishes. Shares without par value, on the other hand, may be issued for such consideration as the board of directors may fix, unless the articles of incorporation reserve this determination to the shareholders. The entire amount of consideration thus received becomes stated capital. Directors, however, within sixty days after the issuance of shares without par value, may allocate to capital surplus not more than twenty-five per cent of the consideration received from their sale. In the case of shares without par value having a preference in voluntary liquidation, a further limitation is imposed, in that not more than the excess over the amount of this preference may be designated as capital surplus.[71]

When payment of the consideration for which shares are to be issued has been received by the corporation, the shares are deemed to be fully-paid and nonassessable, and the stockholder has no obligation to the corporation or its creditors with respect thereto.[72]

Upon the issuance of shares having par value as dividend, a transfer to stated capital of an amount equal to such par value is required. In the case of a stock dividend of shares without par value, the transfer to stated capital of an amount fixed by the board of directors is required.[73] A stock split-up or subdivision, on the other hand, does not require such transfer to capital. Par value also constitutes a limitation on the extent to which shares without par value may be converted into shares with par value, as the stated capital of the corporation represented by the shares without par value is required to be at least equal to the aggregate par value of the shares into which the shares are to be converted.[74]

Each of the revised statutes which has been patterned after the Model Act has followed its structure with respect to provisions governing par, no par, and low par value shares, the consideration required for their issuance, and the accounting procedure to be observed.[75] Under the North Carolina and District of Columbia

[68] MODEL BUSINESS CORPORATION ACT § 14.

[69] *Id.* §§ 53, 55.

[70] *Id.* § 2(j) and (m).

[71] *Id.* §§ 17, 19.

[72] *Id.* § 40(d).

[73] *Id.* §§ 16, 23.

[74] *Id.* § 14(e).

[75] D.C. CODE ANN. §§ 29-908, 29-908c, 29-908d, 29-908e, 29-908f, 29-922 (Supp. 1956); ORE. REV. STAT. §§ 57.080, 57.100, 57.106, 57.111, 57.131, 57.355, 57.365 (Supp. 1955); WIS. STAT. §§ 180.12,

statutes, however, the board of directors is permitted to allocate to paid-in surplus more than twenty-five per cent of the consideration received for shares without par value.[76] The rationale of this departure is that since par value shares may have an insignificant par value, there is no reason for limiting the proportion of the consideration paid for no par value shares that may be allocated to paid-in surplus. The North Carolina statute also makes it clear that par value shares are fully-paid, although issued at a discount representing underwriting compensation.[77]

A variation from the Model Act in the Virginia statute permits corporations to sell par value shares for less than par.[78] The provision was derived from Virginia's previous statute, and in line therewith, "stated capital" for par value shares is limited to the consideration received for their issuance up to par value, unless the directors dedicate any excess to stated capital.[79] Shareholder liability is limited to payment of the full consideration for which the shares were to be issued, and upon its receipt by the corporation, the shares are deemed fully-paid and nonassessable, unless there has been fraud or the stock statement filed with the State Corporation Commission of Virginia does not properly reflect valuation of any property or of services for which the stock was issued.[80]

As will be discussed more fully below, application in the statutes of the defined terms "stated capital" and "capital surplus," together with the term "earned surplus" and in some cases other defined terms, affects the corporation's right to make distributions, to pay dividends, and to acquire its own shares. The concept of par value, through its effect in this connection, is, thus, an important one.

IV

PREFERENCES ON LIQUIDATION AND AS TO DIVIDENDS

Under section fourteen of the Model Act, a corporation, by so providing in its articles of incorporation, may create shares that entitle their holders to preferences over other classes in the assets of the corporation upon its voluntary or involuntary liquidation. This section also permits the establishment of both preferences as to dividends and the right to cumulative and noncumulative or partially cumulative dividends. Preferred classes or special classes of shares may be issued in series which must be identical, except for dividend rates, terms of redemption, amounts payable on voluntary and involuntary liquidation, sinking-fund provisions, and circumstances under which convertibility, if any, is authorized.[81] Such terms may be fixed by the board of directors, if this is so authorized by the articles of incorporation. By amend-

180.14, 180.15, 180.16, 180.50, 180.52 (1955); N.D. Laws 1957, c. 102, §§ 12, 15, 16, 18, 54, 56; TEX. BUS. CORP. ACT arts. 2.12, 2.15, 2.16, 2.17, 2.21, 4.01, 4.03 (1956); VA. CODE ANN. §§ 13.1-12, 13.1-17, 13.1-18, 13.1-55 (Supp. 1956); N.C. GEN. STAT. §§ 55-40, 55-46, 55-47, 55-99 (Supp. 1955).

[76] D.C. CODE ANN. § 29-908e (Supp. 1956); N.C. GEN. STAT. § 55-47(b)(2) (Supp. 1955).

[77] N.C. GEN. STAT. § 55-46(c)(2) (Supp. 1955).

[78] VA. CODE ANN. § 13.1-17 (Supp. 1956).

[79] *Id.* § 13.1-18.

[80] *Id.* § 13.1-22.

[81] MODEL BUSINESS CORPORATION ACT § 15.

ment of the articles of incorporation, a corporation may create new classes of shares which may be senior or junior to existing classes and may effect reclassifications, changes, and exchanges of its shares.[82] Where a senior class is created, however, a class vote is required.[83]

The Model Act contains no requirement that dividends be paid. It does, however, permit payment of preferred dividends in circumstances where payment of other dividends is not permitted. Dividends, except stock dividends and dividends payable out of depletion reserves by a wasting-assets corporation, may be paid only out of the unreserved and unrestricted earned surplus of the corporation.[84] Under section forty-one, however, which covers distributions in partial liquidation, the board of directors of the corporation may distribute dividends to the holders of shares having a cumulative preferential right thereto out of the capital surplus, if the corporation has no earned surplus and is not insolvent at the time. Whenever such distribution is made, however, it must be identified as a payment out of capital surplus.

The Model Act protects liquidation preferences by preventing distributions to and acquisitions of shares which would reduce net assets below the amount of those preferences. Distributions in partial liquidation are, thus, prohibited where they would reduce the remaining net assets below the voluntary liquidation preference of any class of shares.[85] And purchases of other than redeemable shares and purchases in certain other specified circumstances may be made only out of earned surplus or, if the articles of incorporation so provide or if two-thirds of shareholders entitled to vote in the matter approve, out of capital surplus;[86] but redeemable shares may not be redeemed if this would reduce the corporation's net assets below the aggregate amount that would be payable to the holders of preferred shares upon involuntary liquidation.[87] Accordingly, the standard limiting the amounts which may be disbursed in dividends or distributed to or used for acquisitions of shares is the preferential amount to which preferred shares are entitled upon liquidation. The Model Act has been criticized, however, because this criterion permits the depletion of the stated capital of junior shares which would otherwise constitute a cushion of protection to the preferred shareholders.[88]

If the par value of par value shares or the consideration received for no par value shares equals or exceeds liquidation preferences, the stated capital of junior shares, initially at least, affords added protection to the preferred stockholders' liquidation preference. There are various ways, however, in which this cushion can be depleted by corporate action, without approval of the preferred class. Thus, for example, a distribution to common stock in partial liquidation may be made under section

[82] *Id.* § 53.
[83] *Id.* § 55.
[84] *Id.* § 40.
[85] *Id.* § 41(d).
[86] Such other specified circumstances being to eliminate fractions, settle indebtedness to the corporation, or pay dissenting shareholders. MODEL BUSINESS CORPORATION ACT § 5.
[87] *Id.* § 60.
[88] Hackney, *The Financial Provisions of the Model Business Corporation Act*, 70 HARV. L. REV. 1357 (1957).

forty-one, without any vote, if the articles of incorporation so provide, to the full extent of the stated capital of the common stock in excess of liquidation preferences.

Also, by permitting acquisitions and redemptions of shares, the Model Act allows the corporation to reduce the security of preference shares by the stated capital of junior shares. Thus, if permitted by the provisions of the articles of incorporation, or with a vote of two-thirds of the shareholders entitled to vote (without any class vote) if not so permitted, junior shares may be purchased out of capital surplus from the sales of junior shares or even of the senior shares themselves.[89] Although, until the shares are canceled, use of the surplus represented by such shares is restricted with respect to any further purchases of shares, thereafter stated capital is reduced, and surplus is once again freed for further purchases. This permits the use of capital surplus as a revolving fund to reduce stated capital by director action alone, if the articles of incorporation so provide. By permitting the redemption of redeemable junior shares[90] out of stated capital or capital surplus, without any shareholder vote, so long as it does not reduce net assets below preferred share preferences, the Model Act also permits a reduction of stated capital, which affects the margin of security afforded to senior preferred shares by the stated capital of junior shares.[91]

The statutes patterned after the Model Act have, for the most part, also followed its structure with respect to provisions relating to authority to create classes of stock with preferences;[92] and the North Dakota, Oregon, and Wisconsin statutes substantially follow the Model Act with respect to provisions relating to dividends, distributions, and acquisitions of shares as they relate to preferred dividends and the protection of liquidation preferences.[93] The District of Columbia, North Carolina, and Texas statutes, however, have departed from the Model Act with respect to these latter matters.

Under the North Carolina statute, all preferred shares are entitled to a dividend credit—the excess of earnings over dividends from the date of issuance—and until such credit is paid in full, no dividend can be paid on junior shares.[94] This constitutes a pressure on common stock to pay preferred dividends which does not exist under the Model Act, unless made a part of the share contract by the articles of incorporation. Possibly this is a desirable change, but it presupposes that in all circumstances, preferred holders desire ordinary income in the form of dividends. Under current tax laws, situations are certainly conceivable where this is not the case.

[89] MODEL BUSINESS CORPORATION ACT § 5. Capital surplus available for this purpose may be created by reduction of stated capital, either without charter amendment under section sixty-three or by charter amendment without a class vote (unless par value is affected) under section fifty-three.

[90] See *infra* 279-81 for discussion as to creation of redeemable common stocks.

[91] MODEL BUSINESS CORPORATION ACT § 60.

[92] D.C. CODE ANN. §§ 29-908, 29-908a (Supp. 1956); N.C. GEN. STAT. §§ 55-40, 55-41 (Supp. 1955); N.D. Laws 1957, c. 102, §§ 12, 13; ORE. REV. STAT. §§ 57.080, 57.085 (Supp. 1955); TEX. BUS. CORP. ACT arts. 2.12, 2.13 (1956); VA. CODE ANN. §§ 12.1-12, 13.1-13, 13.1-14 (Supp. 1956); WIS. STAT. § 180.12 (1955).

[93] N.D. Laws 1957, c. 102, §§ 5, 40, 41, 63; ORE. REV. STAT. §§ 57.035, 57.216, 57.221, 57.390 (Supp. 1955); and WIS. REV. STAT. §§ 180.38, 180.39, 180.385 (1955).

[94] N.C. GEN. STAT. § 55-40(c) (Supp. 1955).

The North Carolina statute also requires, upon demand of twenty per cent of a class of shares, payment of one-third of the corporation's net profits in a specified period as dividends in cash.[95] This provision, in addition to being subject to the above criticism, by not taking into account the corporation's working capital situation or the prevalence of covenants in debt instruments restricting dividends, may also prove to be impracticable from a business point of view.

The Oregon, Texas, District of Columbia, and North Carolina statutes have, moreover, departed from the Model Act to clarify provisions relating to dividends of corporations exploiting natural resources.[96] In each of these jurisdictions, this provision has been changed so as to emphasize that such dividends are payable out of net profits before deduction of depletion. The Texas statute, in addition, restricts the payment of dividends by wasting-assets corporations if all cumulative preferred dividends have not been fully paid or if such dividends, after provision for actual depletion fairly reflecting the decrease in value of assets from such depletion, would reduce net assets below preferential rights in voluntary liquidation. These provisions, in effect, make applicable to dividends paid by wasting-assets corporations the restrictions on distributions in partial liquidaton of the Model Act relating to full payments in cumulative dividends and preservation of assets sufficient to meet liquidation preferences. Under the Model Act, this is left to the share contract of the preferred stock.

The second class of provisions introduced by the new statutes are those which have increased restrictions on distributions to and acquisitions of shares in order to protect liquidation preferences.

Under the District of Columbia statute, dividends may be paid out of paid-in or reduction surplus.[97] Distributions in partial liquidation may not be made, however, when net assets are less than stated capital and must be authorized by a two-thirds class vote.[98] Also, purchases of shares are restricted where they would reduce the net assets below the sum of stated capital plus surplus other than earned surplus. Redeemable shares, however, may be purchased at a price not exceeding the redemption price, if this would not reduce the net assets below the amount which would be payable on liquidation to holders of shares having a senior or *pari passu* position and in the cases referred to in section five of the Model Act.[99]

Under the Texas statute, dividends, other than stock dividends and dividends paid by wasting-assets corporations, may only be paid out of unreserved and unrestricted earned surplus.[100] Distributions in partial liquidation may be made out of capital surplus or surplus created by a reduction of capital and must be approved by a two-thirds vote of each class.[101] Without such approval, however, dividends may

[95] *Id.* § 55-50(i).
[96] D.C. CODE ANN. § 29-917 (Supp. 1956); N.C. GEN. STAT. § 55-50(d) (Supp. 1955); ORE. REV. STAT. § 57.216 (Supp. 1955); TEX. BUS. CORP. ACT art. 2.39 (1956).
[97] D.C. CODE ANN. § 29-917(b) (Supp. 1956).
[98] *Id.* § 29-917a(d).
[99] *Id.* § 29-904a.
[100] TEX. BUS. CORP. ACT art. 2.38 (1956).
[101] *Id.* art. 2.40.

be paid out of this surplus on shares having a cumulative preferential right thereto.[102] Only shares having a liquidation preference may be redeemable by the corporation, and if such redemption is for an amount greater than the stated capital of the shares redeemed, the excess must be paid out of surplus. Purchases of shares out of unrestricted capital surplus or unrestricted reduction surplus, except in the case of redeemable shares and in the cases specified in section five of the Model Act, may be made only upon a two-thirds class vote of all shares of each class.[103]

Under the North Carolina statute, dividends may be paid out of earned surplus or net profits for the preceding or current accounting period; but on preferred shares, dividends may be paid out of capital surplus if the corporation has no earned surplus, although capital surplus paid in by a senior class may not be used to pay dividends on a junior class.[104] Dividends are restricted if they would result in a reduction of net assets below the aggregate of the highest liquidation preferences of preferred stocks or if the "dividend credit" of preferred stocks has not been fully paid. Distributions on partial liquidation are permitted out of capital surplus and reduction surplus, but only upon a majority class vote. Purchases or redemptions when capital is impaired may be made only of redeemable shares, at prices not exceeding the redemption price, or in the cases specified in section five of the Model Act, or to perform repurchase agreements with employees, or by an open-end investment company to purchase its shares. Junior shares may not be purchased or redeemed when a default exists in the payment of accrued dividends or of the "dividend credit" on any senior shares. Ratable purchases out of surplus may be made of all holders of a class, without any vote of shareholders, or on an organized exchange, with the approval of a majority of the holders of the shares of the class purchased, or from any shareholder, upon vote of a majority of the holders of the shares of the class purchased and of the classes otherwise entitled to vote.[105]

The Virginia statute is less stringent as to dividends, distributions, and acquisitions. Without a vote of shareholders, dividends may be paid out of capital surplus,[106] and purchases and redemptions of shares may be made out of capital surplus.[107]

The variety of the statutory provisions, intended to protect liquidation preferences against dividends, distributions, and acquisitions of shares, raises a basic question as to what the status of preferred stock should be. Should the statutes merely restrict dividends, distributions, and acquisitions so that they do not reduce net assets below liquidation preferences, the standard adopted by the Model Act; or should preferred stocks be entitled to have the cushion of the stated capital of junior

[102] *Id.* art. 2.12B(1).

[103] *Id.* art. 2.03.

[104] N.C. GEN. STAT. § 55-40 (Supp. 1955). Permitting the payment of dividends out of net profits for the preceding or current accounting periods, while seemingly liberal, does directly what can be done indirectly by a reduction of capital. Combining this provision with the "dividend credit" and the requirement that dividends be paid if twenty per cent of a class so request, see notes 94 and 95, *supra*, gives preferred stockholders a strong position under the North Carolina statute.

[105] *Id.* § 55-52.

[106] VA. CODE ANN. § 13.1-43 (Supp. 1956).

[107] *Id.* § 13.1-4.

stocks and surplus other than earned surplus protected against such dividends, distributions, and acquisitions? Under prevalent concepts, there is no necessary relationship between stated capital, capital surplus, and liquidation preferences, so that it is only in the case where such capital accounts exceed liquidating preferences that the latter type of protective provisions would be effective. North Carolina, Texas, and the District of Columbia have sought to protect stated capital and capital surplus by requiring approval by a class vote of shareholders on distributions to and acquisitions of junior shares from these sources. This type of provision gives to a holder of preferred stock rights which a creditor does not have, since without any creditor action, capital can be reduced to the minimum specified in the statutes, usually $1,000, and distributions then can be freely made to stockholders down to that amount. The position of a holder of preferred stock is more precarious than that of a creditor. At a definite date, the corporation's obligation to a creditor becomes due, at which time he can pursue his remedies. This is not true as to preferred stocks, although preferred stock provisions usually include a sinking-fund requirement which produces the same result. Also, preferred stock provisions normally contain their own limitations on dividends, distributions, and acquisitions of shares and frequently reserve to holders the right to elect part of the board of directors when things are not going well.[108] The Model Act type of provision leaves a wide area for bargaining in fixing the terms of a preferred stock, but at the same time, it protects the actual amounts to which preferred shareholders are entitled in liquidation. This type of provision seems preferable to the more clumsy one which becomes operative only if the capital accounts happen to exceed liquidating preferences and which may prevent distributions and acquisitions of shares by the corporation, which would be advantageous to all concerned.

V

Redemption

Section fourteen of the Model Act authorizes the creation of shares redeemable by the corporation. The terms and conditions governing redemption are among the matters which the board of directors may determine for a particular series, if so authorized by the articles of incorporation.[109] By amendment to the articles of incorporation, redeemable classes can be authorized.[110] A corporation may purchase its redeemable shares out of earned or capital surplus without a shareholder vote,[111] but redeemable shares may not be purchased if the corporation is insolvent or the

[108] For a preferred stock to be listed on the New York Stock Exchange, it must provide for the right to elect at least two directors upon default in six quarterly dividends. New York Stock Exchange, Company Manual § A-15 (1956). See also SEC Release No. 13106, Feb. 16, 1956, requiring preferred stocks issued by companies subject to the Public Utility Holding Company Act of 1935, 49 Stat. 803, 15 U.S.C. § 79 (1952), to provide the right to elect a majority of the board if dividends are in arrears for four quarters; and section 367 of the Regulations issued under the California Corporate Securities Law, having a similar requirement.

[109] Model Business Corporation Act § 15.

[110] *Id.* § 53.

[111] *Id.* § 5.

purchase would reduce its net assets below the amount payable in involuntary liquidation to the holders of shares having prior or equal rights.[112] Redemption cancels redeemable shares and, unless the articles of incorporation provide that they may not be reissued, restores them to the status of authorized but unissued shares.[113] This automatically reduces stated capital upon the filing of a statement of cancellation with the secretary of state.

The statutes patterned after the Model Act generally follow its provisions relating to redeemable classes of stock,[114] with the exceptions noted above under the heading "Preferences on Liquidation and as to Dividends" relating to circumstances under which redemptions and purchases of redeemable shares may be carried out. Under the Texas statute, however, only shares having a liquidation preference can be redeemed.[115] But in other states, the authority to create redeemable shares is not so limited. This raises the question as to whether or not redeemable common stocks may be created. In *Starring v. American Hair & Felt Co.*,[116] it was held that the words of the Delaware statute which granted corporations authority to make "preferred and special classes" of stock redeemable, did not contemplate common stock. In *Lewis v. H. P. Hood & Sons*,[117] however, the Supreme Court of Massachusetts construed the similar Massachusetts statute as authorizing the creation of redeemable common stock. The argument that the creation of redeemable common stock was against public policy, in that it destroys the independence of stockholders, was met with the opinion that such redemption could not be exercised oppressively or for the purpose of discriminating against minority stockholders. Also, the court rejected the argument that the inherent nature of common stock is such as to be incompatible with a call provision. While there thus seems to be a division of view as to whether redeemable common stocks can be created, since common stock is normally intended to provide the permanent capital of the corporation, there would appear to be little hardship in Delaware's construction of its statute.

The North Carolina statute provides that the right of redemption must be at the option of the corporation,[118] which is comparable to the California provision.[119] Underlying this type of statute is the belief that stockholders should not have the option to compel redemption of their stock by the corporation at any particular time. Such an option would, it is argued, constitute a continuing threat to working capital and the cash position of the corporation, and, as a practical matter, it would most likely be exercised when the corporation was least able to pay. This theory, however, does not seem sound. After all, management negotiates the terms of any

[112] *Id.* § 60. [113] *Id.* § 61.

[114] D.C. CODE ANN. §§ 29-908, 29-921f (Supp. 1956); ORE. REV. STAT. §§ 57.080, 57.355 (Supp. 1955); WIS. STAT. §§ 180.12, 180.50 (1955); N.D. Laws 1957, c. 102, §§ 12, 54; VA. CODE ANN. §§ 13.1-13, 13.1-55 (Supp. 1956); TEX. BUS. CORP. ACT arts. 2.12, 4.01 (1956); N.C. GEN. STAT. §§ 55-40, 55-99 (Supp. 1955).

[115] TEX. BUS. CORP. ACT art. 2.12B(1) (1956).

[116] 21 Del. Ch. 380, 191 Atl. 887 (Ch.), *aff'd*, 22 Del. Ch. 394, 2 A.2d 249 (Sup. Ct. 1937).

[117] 331 Mass. 670, 121 N.E.2d 850 (1957).

[118] N.C. GEN. STAT. § 55-40 (Supp. 1955).

[119] CAL. CORP. CODE § 1011.

stock, and presumably it is in a position to protect itself against injurious provisions. There may, in fact, be situations in which it would be advantageous from a tax or another viewpoint to grant a put to the shareholder. It would, therefore, seem preferable to leave the question of whether preferred stocks may be redeemable at the option of their holders to negotiation by the parties.

VI

CONVERTIBILITY

Under the Model Act, corporations have the power to create and issue shares convertible into shares of any other class; but, in order to prevent dilution of senior classes, shares may not be convertible into shares of a senior class, and the stated capital represented by no par value shares must be at least equal to the aggregate par value of shares into which they are convertible.[120] If the articles of incorporation so provide, the board of directors may fix the terms on which particular series of a class of shares may be converted.[121] The stated capital of shares issued on conversion is the stated capital of the shares converted, plus the surplus transferred to stated capital, and any additional consideration paid to the corporation.[122]

For the most part, the new statutes which have been based upon the Model Act substantially follow its provisions as to convertibility.[123] The District of Columbia statute, however, does not contain the provision prohibiting convertibility into senior shares.[124] And the Texas statute makes specific provision for including in the terms of convertible shares appropriate antidilution provisions for the protection thereof.[125]

The North Carolina statute, in addition to covering convertible equity securities, includes provisions specifically authorizing the creation of debt securities convertible into capital stock.[126] Moreover, it provides that a corporation must show on its balance sheet the current conversion ratio of outstanding convertible securities and the price at which exercisable and, at all times, must reserve sufficient shares to meet the conversion rights. If such reservation is not made, the right to claim damages exists. And as has been pointed out above, the creation of securities convertible into a class of stock which has pre-emptive rights must be approved by the vote of two-thirds of the holders of such class.

Convertible securities have been popular in recent years because of their associated tax advantages. In the case of convertible debt securities, they afford the holder a fixed income and a creditor status until conversion. If the corporation does well, a capital gain can be realized either by sale of the debt security or by conversion into common stock and the sale of the common stock. The corporation gains

[120] MODEL BUSINESS CORPORATION ACT § 14. [121] *Id.* § 15.

[122] *Id.* § 17.

[123] D.C. CODE ANN. §§ 29-908, 29-908a, 29-908c (Supp. 1956); N.D. Laws 1957, c. 102, §§ 12, 13, 15; ORE. REV. STAT. §§ 57.080, 57.085, 57.100 (Supp. 1955); VA. CODE ANN. §§ 13.1-13, 13.1-14, 13.1-19 (Supp. 1956); WIS. STAT. §§ 180.12, 180.14 (1955); TEX. BUS. CORP. ACT arts. 2.12, 2.13, 2.15 (1956); N.C. GEN. STAT. §§ 55-40, 55-41, 55-44 (Supp. 1955).

[124] D.C. CODE ANN. § 29-908 (Supp. 1956). [125] TEX. BUS. CORP. ACT art. 2.12 (1956).

[126] N.C. GEN. STAT. § 55-44 (Supp. 1955).

an advantage, too, in that pending absorption of the capital produced by sale of the convertible security and the resultant generation of additional earnings, the corporation can deduct interest as an expense. The rate of interest is lower because of the conversion feature. Also, during the period prior to the realization of additional earnings from capital expenditures made with such proceeds, the earnings per share of common stock do not become diluted. Because of the attractiveness of conversion, from both the point of view of the investor and the corporation, it is desirable that statutory provisions relating to convertibility be clarified. The North Carolina statute, by covering these matters, has made a desirable contribution.

CONCLUSION

A good corporate statute should confer maximum flexibility with respect to each share characteristic. A corporation should be permitted to grant, limit, or deny voting powers to particular classes, to grant preferences as to dividends and in liquidation, to make shares redeemable, and to create convertible securities. It should be enabled to make changes in its capital structure to meet the needs of growth, acquire assets by merger and consolidation, and reorganize if it becomes involved in difficulties. Such flexibility should be limited only by reasonable protective provisions. In order to be effectual, a corporate statute must be competitive with the statutes of other states. Otherwise, a state defeats its own purpose in revising its corporate statute, because ambiguity or unusual and impractical provisions will drive businessmen to incorporate elsewhere. The recent statutes, except possibly the Texas statute, solely because of its eighty-per-cent-vote requirement for particular matters, and the North Carolina statute, because of numerous novel provisions, seem adequately to meet the competition. The Model Act has provided an excellent starting point in its clarity, internal consistency, and flexibility. It is, indeed, a credit to its draftsmen that so many jurisdictions have followed it so closely in framing their new corporation statutes.

HOW FIXED ARE CLASS SHAREHOLDER RIGHTS?

George D. Gibson*

I

The Rise and Fall of Vested Rights

"Hereupon is to be collected divers diversities."[1] These related, in the original text, to the feudal law of land. "Apt words of limitation are quamdiu, dummodo, dum, quousque, durante &c. . . ."[2] However apt these words may have been, they seem out of fashion today. Similar changes have occurred in class shareholder rights, and the old words of "vested rights" now seem equally out of fashion. Such rights are now "fixed" only in the sense that they continue until changed by the vote of a specified majority in the manner provided by statute.

Throughout the nineteenth century, land remained the principal form of property. It was natural, therefore, for judges, being students of tradition and for the most part freeholders as well, to approach new forms of property with a solid respect for the principles of real estate law. This was no less true where the issue involved a group of people, as when Leicester Square was set apart by its owner as a "square garden" for the use of all those to whom he sold nearby lots.[3] They were still a small group, and their interests were intensely tangible and personal. It was natural, therefore, as in the case of partnerships, for the courts to require unanimous consent for any substantial change of specified participations.

Corporation law in the modern sense was unknown, apart from limited exceptions in New York, until about 1835.[4] From then on, general acts were adopted with increasing frequency to permit incorporation through standardized procedure without need of special legislative act. By the middle of the century, this had become the customary method of incorporation. But the corporation was still viewed as a mere legal form attributed to a group of individuals, usually a limited group, for the promotion of some particular enterprise. The enterprise itself was limited and not so very different from a "square garden" or a partnership. Indeed, the law was clearly concerned with imposing effective limits on the scope and duration of the

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[1] Co. Litt. 214 b (1809).

[2] Mary Portington's Case, 10 Co. 35 b, 41 b, 77 Eng. Rep. 976, 985 (K.B. 1613).

[3] Tulk v. Moxhay, 2 Ph. 774, 41 Eng. Rep. 1143 (Ch. 1848). See also The Duke of Bedford v. The Trustees of the British Museum, 2 My. & K. 552, 39 Eng. Rep. 1055 (Ch. 1822).

[4] See Dodd, *American Business Association Law a Hundred Years Ago and Today*, in 3 Law: A Century of Progress 1835-1935, 254, 271, 273, 289 (1937); Adolph A. Berle, Jr., and Gardiner C. Means, The Modern Corporation and Private Property 136 (1932).

undertaking.[5] A definite time limit was usually imposed on the continuation of the corporate existence. The powers that might be exercised were sparingly enumerated, rather than by general grant. The incorporators or directors were often required to be residents of the domiciliary state. There was no power to hold stock in other corporations. And all of these limitations were enforced with a strict eye. This may reflect an uneasy recollection of the vast holdings of property by the Church in England, and, indeed, in all of Europe, until the sixteenth century. But in any event, the policy of restraint is clear.

If we say that America's greatest need at the end of the eighteenth century was political independence from Europe, we may equally agree that her greatest need in the second half of the nineteenth century was the multiplication of property. New means were provided by the techniques of the industrial revolution. New necessities were presented in the subjugation of the continental wilderness, which was a supreme opportunity and challenge. Throughout this period, accordingly, and for another third of a century as well, the aspects of property received special veneration. The social need combined with feudal tradition for this result. The astonishing advances in material prosperity that ensued made it easy to accept the supremacy of property as a natural and sufficient postulate.

This postulate received some of its most striking illustrations in court decisions on attempts to amend corporate charters. Rules of feudal rigidity were built up on the basis of a prior decision that had been rendered in a different context with regard to Dartmouth College.[6]

Before the days of the American business corporation, the Supreme Court had been faced by an attempted appropriation of an institution established in corporate form by royal charter. The Trustees of Dartmouth College were entitled by charter to appoint their own successors in perpetuity. On this basis, considerable sums had been bequeathed them by Lord Dartmouth for the "education of the American savages." After the Revolution, it occurred to New Hampshire that a more agreeable scheme would be for all the Trustees to be appointed by the Governor. So, it adopted an act purporting to amend the charter to this effect. This attempt to "nationalize" the control of Dartmouth was, in some respects, similar to the Egyptian expropriation of the Suez Canal. The change, intensely simple, was one by which "the will of the state is substituted for the will of the donors, in every essential operation," and, in consequence, the "system is totally changed" so as to be "subversive of that contract."[7] The Supreme Court held this invalid under the Federal Constitution.[8] No such difficulties would exist, Mr. Justice Story added in his concurring opinion, if "a power be reserved for this purpose" of later amend-

[5] See Louis K. Liggett Co. v. Lee, 288 U.S. 517 (1933).

[6] Trustees of Dartmouth College v. Woodward, 17 U.S. (4 Wheat.) 518 (1819).

[7] *Id.* at 652-53.

[8] This was under the contracts clause, U.S. CONST. art. I, § 10, cl. 1, but the same result was later reached under the due process clause. *Id.*, amend. XIV, § 1. See Smyth v. Ames, 169 U.S. 466, 522, 526 (1898) (dictum). *But see* Munn v. Illinois, 94 U.S. 113 (1877).

ment.[9] This cue was immediately followed by many states, and such reservations of power became customary.

As a simple matter of common sense, one would have supposed that the reservation of unlimited power of amendment of corporate charters would have made, as it was no doubt intended to do, the *Dartmouth College* case wholly inapplicable in subsequent corporation law. But judges seek what they think the country needs most. With feudal recollections and guided by the dominant role of property in augmenting the American empire at that time, the judges set about to find "divers diversities" that might limit and defeat the reserved power of amendment. First, they extended the underlying premise of the *Dartmouth College* case. As decided, it did not involve a change by majority vote of the owners. Rather, it involved a state seizure of control of a private institution and its property. For all that, it was now extended so that, as in the case of realty and partnerships, the shareholder's interest, however defined in the charter, was constitutionally immune from any substantial change, except by his individual consent.

This made it necessary to inquire whether there had been "consent" in each particular case. The concept of consent comes from the law of private contracts. It is not an altogether easy matter to determine when there has been a meeting of minds between two men. It is decidedly more complicated to determine when there has been a meeting of minds between an individual investor and the sovereign, who can be found only in shifting groups of spokesmen and often enough expresses his will in Delphic phrases that become precise only with the slow elucidation of experience. But it is natural to deal with a new problem in terms of accepted tradition. There could be little doubt that consent is given if the power to amend on the assent of a stipulated majority was proclaimed in terms in the charter. If a purchaser assents to anything, he assents to that.[10] But there should be no more doubt where the right is reserved in the code or constitution of the domiciliary state. While these are more difficult to locate and often to understand, it is elemental that the law of the state at the time of issuing the charter is a part of the charter as fully as if printed in the text of the charter itself.[11] It would seem to follow, therefore, as the modern cases hold, that there can be no impairment of contracts, and no taking of property, where the right to make the amendment is reserved by law.[12]

But for a long time, it was not so simple. The elaboration of the "consent" doctrine led to many scholarly "diversities." One line of cases held that the power

[9] 17 U.S. (4 Wheat.) at 675.

[10] Western Foundry Co. v. Wicker, 403 Ill. 260, 85 N.E.2d 722 (1949).

[11] De Mello v. Dairyman's Co-Operative Creamery, 73 Cal. App. 2d 746, 167 P.2d 226 (1946); Beloff v. Consolidated Edison Co. of N.Y., 300 N.Y. 11, 87 N.E.2d 561 (1949); Franzblau v. Capital Securities Co. 2 N.J. Super. 517, 64 A.2d 644 (Ch. 1949); Sherman v. Pepin Pickling Co., 230 Minn. 87, 41 N.W.2d 571 (1950); Midland Truck Lines, Inc. v. Atwood, 362 Mo. 397, 241 S.W.2d 903, 904-05 (1951); Opdyke v. Security Savings & Loan Co., 157 Ohio St. 121, 105 N.E.2d 9 (1952); *In re* Mayellen Apartments, 134 Cal. App. 2d 298, 285 P.2d 943 (1955).

[12] McNulty v. W. & J. Sloane, 184 Misc. 835, 54 N.Y.S.2d 253 (Sup. Ct. 1945); Donohue v. Heuser, 239 S.W.2d 238, 241 (Ky. 1951).

of amendment reserved by statute should be so narrowly read as to include only those aspects of the corporate charter affecting relations with the state and, thus, to have no bearing at all on any proposed change of the class shareholder rights.[13] As far as corporate readjustments were concerned, the result was the same as if there had been no reserved power at all and hence no "consent." A second line of cases held that even if the legislative authorization for charter changes dealt unmistakably with changes of class right, still it would not be applied to any particular change unless that particular change was itemized specifically in the statute. If some other name could be found for the change, as the resources of the bar and bench ordinarily permit, it was held beyond the reserved power. It was quite plain that when the judges considered property rights to be in risk, they would not listen to the legislature if they could find any way to avoid it. And, of course, they generally could. For example, although the Delaware legislature reserved the power for any alteration of "preference" upon a majority assent of the adversely-affected class, the Delaware courts held that accrued dividends of preferred stock were a "vested right" rather than a "preference" and, thus, beyond the scope of the reserved power.[14] A third line of cases held that even if the reserved power was unmistakably clear and unassailably specific, nevertheless, it would not be applied to stock issued prior to the enactment of the statute.[15]

The flood tide of this judicial preoccupation with the fixed rights of private property, as well as its turn and ebb, can be found in the treatment given the Delaware legislation of 1927 broadening its amendment statute to include all "special rights" as well as "preferential rights." This was generally understood to permit the elimination of preferred arrears.[16] Many transactions were accomplished on that premise. But then the Delaware Supreme Court unexpectedly held the new words inapplicable to previously-issued stock.[17] The "vested rights" doctrine, however, had outlived its usefulness. Soon afterwards, the Delaware court found a way to permit changes to be made without regard to the calendar. It would uphold them so long as they were accomplished through the formal variant of a merger, even with a wholly owned subsidiary.[18]

In retrospect, it is now apparent that this marked the end of "vested rights,"

[13] For this result, a philosophy was presupposed by which a corporate charter is simultaneously three contracts: (1) a contract among the shareholders, (2) a contract between the shareholders and the corporation, and (3) a contract between the corporation and the state. See, *e.g.*, Pronik v. Spirits Distributing Co., 58 N.J. Eq. 97, 42 Atl. 586 (Ch. 1899). State reservation statutes have all been interpreted as applying to corporate charters in so far as they are contracts between the corporation and the state.

[14] Morris v. American Pub. Util. Co., 14 Del. Ch. 136, 122 Atl. 696 (Ch. 1923).

[15] *E.g.*, Yoakam v. Providence Biltmore Hotel Co., 34 F.2d 533 (D. R.I. 1929).

[16] See Harr v. Pioneer Mechanical Corp., 65 F.2d 332 (2d Cir. 1933), *cert. denied*, 290 U.S. 673 (1933).

[17] Keller v. Wilson & Co., 21 Del. Ch. 391, 190 Atl. 115 (Sup. Ct. 1936).

[18] Federal United Corp. v. Havender, 24 Del. Ch. 318, 11 A.2d 331 (Sup. Ct. 1940); Porges v. Vadsco Sales Corp., 27 Del. Ch. 127, 32 A.2d 148 (Ch. 1943). And see Langfelder v. Universal Laboratories, Inc., 68 F. Supp. 209 (D. Del. 1946), *aff'd*, 163 F.2d 804 (3d Cir. 1947); Hottenstein v. York Ice Mach. Corp., 136 F.2d 944 (3d Cir. 1943), *cert. denied*, 325 U.S. 886 (1945).

though the tide did not turn instantaneously and equally in all places.[19] If particular aspects of a shareholder's interest were constitutionally immune from any substantial change, except on his consent, which is the "vested rights" doctrine, they would be no more subject to change by mere difference in technical procedure, whether or not accompanied by a cash-appraisal right. He would be constitutionally entitled to keep what he had and could not be forced to give it up for another form of property corresponding in another person's judgment to the value of what he liked. Logically, he could no more be forced to exchange his interests for cash than he could be forced to exchange them for stock. So when it was held constitutional to force an unwilling shareholder to accept money in a merger, it was only a question of time before logic and common sense would sweep away purely formal distinctions and, thus, eliminate what still remained of "vested rights."

The real determinants of the courts' new approach to changes in the corporate structure are not, however, to be found in the rationale of the early cases. The reasoning of *Havender*[20] was as technical as *Keller*.[21] But technicalities can be a workmanlike device for opening a passage when that is being done for the first time. After *Havender,* we cannot doubt that the door was opened to remain open. The courts, at last, had recognized that a new world had grown up outside the courtrooms that could no longer be measured in the old Euclidian terms. The new spaces of the industrial world, like those of the physical, required a new philosophical formulation. Relativity was as applicable to one as to the other.

Instead of a neighborhood railroad which could not be extended except on unanimous consent,[22] the new systems ran from the Atlantic to the Mississippi or thence to the Pacific, often with bus and air subsidiaries. The neighborhood power house had become an electric utility system serving a connected territory in several states. The neighborhood flour or textile mill had become a vast organization owning its sources of raw material throughout the world, manufacturing wherever economy indicated, and selling in the national market and beyond.

The statistical measure of these changes, ideally, would be a cumulative summary of the family corporations of fifty years ago, for example, that are now owned by the public, contrasting their assets, earnings, and number of stockholders at that earlier time with the present. But those figures are inaccessible. The pace of change can be illustrated, however, in other ways. The number of companies with securities listed on the New York Stock Exchange, which presupposes public distribution, has substantially tripled since the end of 1913, increasing from an estimated 350 at that time to 1105 on August 31, 1957. During this period, the number of listed shares increased from 151,000,000 at the end of 1913, to 808,000,000 at the beginning of 1929, and thence to 4,719,000,000 on August 31, 1957. Between the last two dates, their

[19] A more detailed analysis of the judicial decisions is made in Gibson, *The Virginia Corporation Law of 1956*, 42 VA. L. REV. 445, 603, 606-08 (1956).

[20] Federal United Corp. v. Havender, 24 Del. Ch. 318, 11 A.2d 331 (Sup. Ct. 1940).

[21] Keller v. Wilson & Co., 21 Del. Ch. 391, 190 Atl. 115 (Sup. Ct. 1936).

[22] See Zabriskie v. Hackensack & N.Y.R.R., 18 N.J. Eq. 178 (Ch. 1867).

aggregate market value increased from $71,000,000,000 to $218,000,000,000. This is undeniably an important segment of the economy. Particularizing, we can take the twenty American corporations that are most widely owned by the public today and trace their growth since 1913 in the following tables.

TABLE A
TOTAL ASSETS PER BOOKS
(in millions)

Company	1913[23]	1929[24]	1957[25]
American Tel. & Tel.	$ 656	$4,228	$17,678
General Motors	58	1,325	6,826
Standard Oil (N. J.)	a	1,767	8,712
General Electric	144	492	2,361
Ford Motor	a	a	3,114
United States Steel	1,800	2,286	4,074
Socony Mobil Oil	94	815	3,105
Cities Service	b	1,090	1,279[d]
Radio Corp.	b	117	721
DuPont	74	542	3,552
Pennsylvania R. R.	940	2,078	2,991
Standard Oil (Ind.)	49	697	2,535
Commonwealth Edison	88	376	1,460
Consolidated Edison (N. Y.)	164	699	1,829
Westinghouse Electric	83	254	1,401
Public Service Electric & Gas	c	c	1,061
Standard Oil (Calif.)	88	605	2,246
Pacific Gas & Electric	204	454	2,146
Texas Co.	68	527	2,729
Southern Co.	c	c	1,037

Key: a—not published
b—company not in existence
c—not separately available because part of a holding company system
d—reflects divestment of utility properties

The revenues collected are a more realistic measure of their participation in the economy.

This is a different world, indeed. To look only at the first two, a service enterprise that was being paid by the economy in the order of $215,000,000 in 1913 (and paying out correspondingly for labor, capital, plant) had grown to a $1,000,000,000-size in 1929 and has grown beyond the $5,000,000,000-size today; and a manufacturing enterprise, merely a starter in 1907, exceeded $1,000,000,000 in 1929 and exceeds $10,000,000,000 today.

The number of shareholders in these same corporations reveals in another way how far they have moved from the relationship of neighbors or partners.

[23] POOR'S MANUAL OF INDUSTRIALS (1914); POOR'S MANUAL OF PUBLIC UTILITIES (1914).
[24] MOODY'S INDUSTRIALS (1933); MOODY'S PUBLIC UTILITIES (1933); MOODY'S RAILROADS (1930).
[25] MOODY'S INDUSTRIALS (1958); MOODY'S PUBLIC UTILITIES (1958); MOODY'S RAILROADS (1958).

TABLE B

GROSS REVENUES
(in millions)

Company	1913[26]	1929[27]	1957[28]
American Tel. & Tel.	$215	$1,071	$ 6,313
General Motors	[8][e]	1,504	11,085
Standard Oil (N. J.)	a	1,523	7,830
General Electric	106	415	4,336
Ford Motor	a	a	5,771
United States Steel	796	1,494	4,414
Socony Mobil Oil	[16][e]	[64][e]	2,976
Cities Service	b	184	1,046[d]
Radio Corp.	b	159	1,176
DuPont	27	82	2,000
Pennsylvania R. R.	185	182	987
Standard Oil (Ind.)	a	[85][e]	2,010
Commonwealth Edison	17	83	380
Consolidated Edison (N. Y.)	14	223	553
Westinghouse Electric	40	216	2,009
Public Service Electric & Gas	c	c	322
Standard Oil (Calif.)	[19][e]	70	1,651
Pacific Gas & Electric	16	64	501
Texas Co.	26	213	2,344
Southern Co.	c	c	255

Key: a—not published
b—company not in existence
c—not separately available because part of a holding company system
d—reflects divestment of utility properties
e—after expenses

TABLE C

NUMBER OF SHAREHOLDERS[29]

Company	1957
American Tel. & Tel.	1,490,000
General Motors	640,473
Standard Oil (N. J.)	403,000
General Electric	366,524
Ford Motor	298,918
United States Steel	257,997
Socony Mobil Oil	181,605
Cities Service Co.	174,496
Radio Corp.	158,397
DuPont	153,832
Pennsylvania R. R.	144,468
Standard Oil (Ind.)	143,225

[26] POOR'S MANUAL OF INDUSTRIALS (1914); POOR'S MANUAL OF PUBLIC UTILITIES (1914).
[27] MOODY'S INDUSTRIALS (1933); MOODY'S PUBLIC UTILITIES (1933); MOODY'S RAILROADS (1930).
[28] MOODY'S INDUSTRIALS (1958); MOODY'S PUBLIC UTILITIES (1958); MOODY'S RAILROADS (1958).
[29] The Exchange (published by New York Stock Exchange), March 1957, p. 7.

Commonwealth Edison	143,009
Consolidated Edison (N. Y.)	142,623
Westinghouse Electric	139,201
Public Service Electric & Gas	137,404
Standard Oil (Calif.)	137,381
Pacific Gas & Electric	135,454
Texas Co.	131,035
Southern Co.	121,954

At the present time, 8,600,000 people own shares in American business corporations.[30] This represents a thirty-three per cent increase in the four years from 1952 to 1956.[31] Over two-thirds of these holders have incomes of less than $7,500 a year. And the end is not yet. It has been estimated that during the decade ending in 1965, an increase of roughly forty per cent will be realized in each of gross national product, public construction, disposable income, and consumer expenditures.[32] This will require large increases in the physical plant of the economy. It will also require large-scale financing. It is estimated that during the decade ending in 1965, American business corporations will need to raise "$60 billions in outside equity money" for the enlargement of their plant and equipment, or three times the volume of new stock financing in the last ten years.[33] Financing of this extent will require resort to the American people for additions to their individual investments.

These developments are propelled by the "deepest force of the time," which is the aspiration of the masses of the people for increased participation in the new products made available by science.[34] This necessitates production and distribution in the largest volume. This has been possible only though the astonishing growth of the American business corporation. It has grown in size, spread throughout the United States, overrun its political boundaries, and enlisted the investments of increasing millions of citizens. It continues to grow by its own concentration of ability and method. Thus, it has become a "political institution,"[35] "a quasi-governing agency."[36] It is now a participant in the administration of affairs in a degree of importance having both national and international interest. This diversification of activity is essential not only to business, but also to government itself, since no modern state can hope to defend itself within the resources of its own political frontiers.[37]

In such a perspective, the old reasoning of private contract law has lost its savor, just as the feudal words "quamdiu," "dummodo," etc. seem out of fashion now.

[30] NEW YORK STOCK EXCHANGE, WHO OWNS AMERICAN BUSINESS? 12-13 (1956).

[31] *Id.* at 5.

[32] Projection by the Joint Committee on the Economic Report, charted in POOR'S INVESTMENT ADVISORY SURVEY 274 (1957).

[33] Address by G. Keith Funston, *New Steps to Strengthen the Rights of Stockholders,* General Management Conference of the American Management Association, June 4, 1957.

[34] ADOLPH A. BERLE, JR., THE 20TH CENTURY CAPITALIST REVOLUTION 164 (1954).

[35] *Id.* at 60.

[36] *Ibid.*

[37] See ADOLPH A. BERLE, JR., TIDES OF CRISIS 16-17 (1957).

As a corporation loses its neighborhood aspect and takes on the character of a political institution, it is of national concern that the corporation have flexibility to adapt itself to new challenges and new problems arising in our ever-changing economy. It becomes necessary that rearrangement of its capitalization with the shifting tides of business need should be accomplished like other practical decisions. This means that changes can be made by the majority within the procedural limitations set up by statute to safeguard the minority from abuse. No veto by a small group can be tolerated. However suitable the rule of unanimity might be for a partnership, it is wholly unsuited to political institutions.[38]

In formal terms, this means the disappearance of the doctrine of "vested rights." And now, where a statute authorizes change, no limit is to be drawn on the power of the corporation to make changes of any nature and extent in the rights of shareholders, so long as the requisite proportion of the affected class assent. Conversely, modifications of class-shareholder rights will present no justiciable question, except where noncompliance with the statute or fraud is alleged. This is on the simple ground that if the amendment is authorized by statute, the legislature has spoken and judges should not deny its effect by substituting their own notions of public policy.[39] The logic of this approach is just as applicable to the recapitalization or extinguishment of preferred arrears[40] as it is to the modification of other shareholder "rights," though in this particular area, the old rule has been given up with special reluctance because of the semblance of retrospective change.[41] No provision of the federal or state constitutions forbids giving full effect to such legislation. This has long been recognized in New York.[42] It is increasingly the prevailing view elsewhere.[43] Indeed, a survey of judicial history since *Havender* reveals no landmark decision reinvigorating the old doctrine of "vested rights."

[38] Medieval Poland required unanimous consent for the choice of a king. But in consequence, the electors spent all their time maneuvering for decision, without opportunity to attend to the business of the state.

[39] Bedinger v. Graybill's Executor & Trustee, 302 S.W.2d 594 (Ky. 1957).

[40] Western Foundry Co. v. Wicker, 403 Ill. 261, 85 N.E.2d 722 (1949); Anderson v. Cleveland-Cliffs Iron Co., 87 N.E.2d 384 (Ohio C.P. 1948), 18 U. CIN. L. REV. 539 (1949). See also Waterbury, *Corporations—Dividends—Elimination of Dividend Accumulation by Direct Charter Amendment*, 48 MICH. L. REV. 657 (1950).

[41] Janes v. Washburn Co., 326 Mass. 356, 94 N.E.2d 479 (1950), 30 B.U.L. REV. 574 (1950), 37 VA. L. REV. 318 (1951); Schaad v. Hotel Easton Co., 369 Pa. 486, 87 A.2d 227 (1952).

[42] Garzo v. Maid of the Mist Steamboat Co., 303 N.Y. 516, 104 N.E.2d 882 (1952); Liebschutz v. Schaffer Stores Co., 276 App. Div. 1, 93 N.Y.S.2d 125 (4th Dep't 1949), *aff'd*, 279 App. Div. 96, 108 N.Y.S.2d 476 (3d Dep't 1951); Arstein v. Robert Reis & Co., 77 N.Y.S.2d 303 (Sup. Ct. 1948), *aff'd*, 273 App. Div. 963, 79 N.Y.S.2d 314 (1st Dep't 1948); McNulty v. W. & J. Sloane, 184 Misc. 835, 54 N.Y.S.2d 253 (Sup. Ct. 1945); Hinckley v. Schwarzchild & Sulzberger Co., 107 App. Div. 470, 95 N.Y. Supp. 357 (1st Dep't 1905). See also Anderson v. International Minerals & Chem. Corp., 295 N.Y. 343, 67 N.E.2d 573 (1946); Davison v. Parker, Austin & Lipscomb, Inc., 285 N.Y. 500, 35 N.E.2d 618 (1941).

[43] Metzger v. George Washington Memorial Park, Inc., 380 Pa. 350, 110 A.2d 425 (1955); French v. Cumberland Bank & Trust Co., 194 Va. 475, 74 S.E.2d 265 (1953); Donohue v. Heuser, 239 S.W.2d 238 (Ky. 1951); Sherman v. Pepin Pickling Co., 230 Minn. 87, 41 N.W.2d 571 (1950); Western Foundry Co. v. Wicker, 403 Ill. 260, 85 N.E.2d 722 (1949); Franzblau v. Capital Securities Co., 2 N.J. Super. 517, 64 A.2d 644 (Ch. 1949); Dratz v. Occidental Hotel Co., 325 Mich. 699, 39 N.W.2d 341 (1949); Porges v. Vadsco Sales Corp., 27 Del. Ch. 127, 32 A.2d 148 (Ch. 1943); Hubbard v. Jones

This is not to say that shareholder interests have lost all protection under the Constitution. They retain such protection as comparable types of property enjoy. But it does mean that there is no constitutional requirement for unanimous assent for changes of class shareholder rights. Assuming the reservation of a power to amend, the assent of the statutory majority is sufficient and binding on all non-assenting members of the class, regardless of the times when the stock was issued and the statute enacted. Since these statutes were enacted to keep the agencies of business healthy and adaptable to changing business conditions, it is important that the same rules apply uniformly to all corporations, without regard to the time of their organization and financing.[44]

The disappearance of "vested rights" in the sense of a requirement for unanimous consent before any change of important right is even more conspicuous in the pattern that has been followed by all new legislation in the last ten years. Beginning in 1946, thirteen states have adopted complete new corporation codes or largely amended their existing law. In every instance, these new provisions purport to authorize any kind of change, whatever its nature or extent, when approved by a specified proportion of the shareholders. In most instances, stockholders are protected against changes of a substantially adverse nature by requiring the assent of two-thirds of the affected class, voting separately, even though not otherwise entitled to vote at all by the terms of the charter. There is great merit in requiring that at least two out of every three adversely affected stockholders must favor the change. This high requirement will exert an influence on the formulation of the plan and, when satisfied, provides a strong practical assurance of the will of the owners. Where a two-thirds vote is required, none of the new statutes provides the alternative of a cash appraisal. Among the new statutes, that extraordinary remedy is confined to those that do not require a class vote or, if any, require no more than a majority assent.[45]

& Laughlin Steel Corp., 42 F. Supp. 432 (W.D. Pa. 1941); Winfree v. Riverside Cotton Mills Co., 113 Va. 717, 75 S.E. 309 (1912). And see HENRY W. BALLANTINE, CORPORATIONS 648-50 (rev. ed. 1946); Gibson, *supra* note 19, at 603-19; Dodd, *Accrued Dividends in Delaware Corporations from Vested Right to Mirage*, 57 HARV. L. REV. 894 (1944); Latty, *Fairness—The Focal Point in Preferred Stock Arrearage Elimination*, 29 VA. L. REV. 1, 51 (1942); Dodd, *Dissenting Stockholders and Amendments to Corporate Charters*, 75 U. PA. L. REV. 585, 723 (1927).

The states still applying the old doctrine are exceptional. *E.g.*, Schaffner v. Standard Boiler & Plate Iron Co., 150 Ohio St. 454, 83 N.E.2d 192 (1948); Wheatley v. A. I. Root Co., 79 Ohio App. 93, 72 N.E.2d 482 (1945), *modified on appeal*, 147 Ohio St. 127, 69 N.E.2d 187 (1946); Clark v. Henrietta Mills, 219 N.C. 1, 12 S.E.2d 682 (1941); Patterson v. Henrietta Mills, 219 N.C. 7, 12 S.E.2d 686 (1941); Patterson v. Durham Hosiery Mills, 214 N.C. 806, 200 S.E. 906 (1939).

[44] Thus, the Virginia Code Commission said: "It is important in the public interest that the same rules apply to present corporations and securities as to new ones and thus that the Act apply in full force to corporations existing and securities outstanding at its effective date." CODE COMMISSION OF VIRGINIA FOR REVISION OF THE LAWS RELATING TO CORPORATIONS, REPORT 94 (1955).

[45] The cash-appraisal remedy is a substantial handicap to management. See, *e.g.*, NEW YORK BAR ASSOCIATION COMMITTEE ON CORPORATION LAW, REPORT 75, 80 (1957). The protection it affords the shareholder is often largely formal, and it is generally thought "unsatisfactory." See Dodd, *Fair and Equitable Recapitalizations*, 55 HARV. L. REV. 780, 816 (1942); *cf.* Note, *Interplay of Rights of Stockholders Dissenting from Sale of Corporate Assets*, 58 COLUM. L. REV. 251 (1958). *But cf.* Skoler, *Some Observations of the Scope of Appraisal Statutes*, 13 BUSINESS LAWYER 240, 245-53 (1958).

The outlines of this new legislation are shown in the following table. The Model Act referred to is that prepared by the Committee on Corporate Law of the American Bar Association (the latest revision being in 1957).

TABLE D

NEW LEGISLATION

State	Date	Nature
Kentucky	1946	"Any change in preferences, special rights or powers" upon a two-thirds class vote, without any alternative. KY. REV. STAT. §271.445. (1955)
Oklahoma	1947	Specific enumeration of all known changes, upon a majority vote of the affected class, with cash appraisal right. OKLA. STAT. tit. 18, §§1.153-57 (1951).
Maryland	1951	Specific enumeration of all known changes, upon a two-thirds vote, without a class vote unless so provided by charter but with right of cash appraisal. MD. ANN. CODE. art. 23, §§10-11 (1951).
Wisconsin	1951	The Model Act (specific enumeration of all known changes, upon a two-thirds class vote, with no alternative). WIS. STAT. §§180.51-52 (1955).
Oregon	1953	The Model Act, as above. ORE. REV. STAT. §§57.355-65 (Supp. 1955)
Florida	1953	Any change in "preference, or . . . rights", upon a majority class vote, with no alternative. FLA. STAT. §608.18 (1955).
District of Columbia	1954	The Model Act, as above, except the clause authorizing the cancellation of rights to accrued, but undeclared, dividends is omitted. D. C. CODE ANN. §§29-921f-22 (Supp. 1956).
Texas	1955	The Model Act, as above. TEX. BUS. CORP. ACT. arts. 4.01-.03 (1956).
North Carolina	1955	Specific enumeration of all known changes, upon a majority class vote, with cash appraisal. N. C. GEN. STAT. §§55-99-101 (Supp. 1955).
Virginia	1956	The Model Act, as above. VA. CODE ANN. §§13.1-55-57 (Supp. 1956), as amened, Va. Acts 1958, c.564.
North Dakota	1957	The Model Act, as above. N. D. Laws 1957, c.102, §§54-56.
Alaska	1957	The Model Act, as above. Alaska Sess. Laws 1957, c.126, §§53-55.
Colorado	1958	The Model Act, as above. Colo. Laws 1958, S. B. 14 (effective January 1, 1959).

All these statutes confer the power of amendment in the broadest possible terms. While in two instances, the words are general in nature, they are, nevertheless, unlimited. The others take pains to enumerate all familiar types of modifications of class rights that had been reviewed by the courts, thus foreclosing any possibility of a

restrictive interpretation. It is noteworthy that none confers or contemplates any power of review, whether administrative or judicial, on grounds of fairness. This was for no want of example or precept. Examples are available, but unappealing.[46] And precept was profuse, though unconvincing.[47]

This decade of legislation, in which about a quarter of the states rewrote their corporation statutes deliberately to preclude review for "fairness," followed immediately upon a decade which had been largely occupied in enforcing a "fairness" test in corporate rearrangements of wide diversification. Fairness in railroad reorganizations under section seventy-seven of the Bankruptcy Act or chapter fifteen had been litigated endlessly.[48] Experience with industries under section 77B or chapter ten had been comparable.[49] Even the expert administrative agencies had found difficulties under section eleven of the Public Utility Holding Company Act[50] and under section five of the Interstate Commerce Act.[51] While such may be the rocky road to follow

[46] Administrative review is available uniquely in California by the definition of "sale" in the Blue Sky law. CAL. CORP. CODE § 25009. An example of the uncertainties that result is afforded by the pending litigation of Western Airlines with the California Commissioner over the charter amendment approved by a 59% vote of its stockholders to eliminate cumulative voting. Western Airlines is a Delaware corporation; but in view of this litigation arising out of California law, the amendment has been withheld. See Seward, *The Movement for Modernization of State Corporation Laws*, Commercial and Financial Chronicle, July 11, 1957. Judicial review is available uniquely in Nebraska, under a statute permitting any adversely-affected stockholder to apply to any court of competent jurisdiction to enjoin amendments "on the grounds of fraud or unfairness," with the requirement that the court enjoin the amendments if the proponents "fail to show that, to a reasonable probability, they are fair, just, and equitable." NEB. REV. STAT. § 21-1162 (1954). Court review is also available in England by statute permitting any adversely-affected shareholder to apply to a court, which may disallow the amendment "if satisfied, having regard to all the circumstances of the case, that the variation would unfairly prejudice the shareholders" of that class. Companies Act, 1948, 11 & 12 GEO. 6, c. 38, § 72.

[47] See, *e.g.*, Latty, *Exploration of Legislative Remedy for Prejudicial Changes in Senior Shares*, 19 U. CHI. L. REV. 759 (1952); Walter, *Fairness in State Court Recapitalization Plans—a Disappearing Doctrine*, 29 B.U.L. REV. 453 (1949); Note, 69 HARV. L. REV. 538, 543 (1956). The more thoughtful commentators recognized that "fairness" is too vague and difficult to apply in practice. See Becht, *Alteration of Accrued Dividends*, 49 MICH. L. REV. 363, 565, 588-92 (1951); Becht, *Corporate Charter Amendments, Issues of Prior Stock and the Alteration of Dividend Rates*, 50 COLUM. L. REV. 900 (1950); Becht, *Changes in the Interests of Classes of Stockholders by Corporate Charter Amendments, Reducing Capital and Altering Redemption, Liquidation and Sinking Fund Provisions*, 36 CORNELL L.Q. 1 (1950); Note, 37 CORNELL L.Q. 768 (1952).

[48] *E.g.*, Insurance Group Comm. v. Denver & R.G.W.R.R., 329 U.S. 607 (1947); RFC v. Denver & R.G.W.R.R., 328 U.S. 495 (1946); Group of Institutional Investors v. Chicago, M., St.P. & Pac. R.R., 318 U.S. 523 (1943); Ecker v. Western Pac. R.R., 318 U.S. 448 (1943). For a discussion of the difficulties involved in evaluating railroad assets in a reorganization, a process which must underlie any attempt to ascertain the "fairness" of any proposed plan, see Wren, *The Valuation of a Railroad in Reorganization*, 58 COLUM. L. REV. 316 (1958).

[49] See Consolidated Rock Products Co. v. DuBois, 312 U.S. 510 (1941); Case v. Los Angeles Lumber Products Co., 308 U.S. 106 (1939). The Securities and Exchange Commission is still redefining the standards. See In the Matter of Geren River Steel Corp., Corp. Reorg. Release No. 105, Jan. 24, 1957, p. 21.

[50] See SEC v. Central-Illinois Securities Corp., 338 U.S. 96 (1949); Otis & Co. v. SEC, 323 U.S. 624 (1945).

[51] See Schwabacher v. United States, 334 U.S. 182 (1948). The difficulties in applying a test of "fairness" to corporate readjustments do not result from the imprecision of that term alone. They are inherent in the intrinsic vagueness of any standard, however defined, with which one attempts to weigh complex economic conjectures. Thus, the same uncertainties have been met under § 20b of the Interstate Commerce Act, where the plan must be found to be "in the best interests" of each class.

where creditors can not be satisfied or special public policies are to be enforced, the states have chosen a different road for the modification of class shareholder rights in the case of the ordinary solvent corporation. The reason has primarily been the belief, characteristically American in nature, that it ought to be possible to consummate practical transactions without having to stop first to conclude exhaustive examinations into matters that are largely indeterminable. Three contributing reasons may be noted. As the rate of economic change has quickened and corporations have grown in size, the practical pressures for completing a plan expeditiously have increased. The same growth has been accompanied by a dispersal of stock ownership that has tended to separate management from domination by a cohesive group of stockholders. This has reduced the dangers of insider preference. Finally, the question of fair treatment involves a balancing of different investment attributes in the light of prospective future earnings, which is not pre-eminently adapted to the judicial expertise.

The extent to which the decisions and statutes discussed above cover corporate business in the United States can be judged from the following table identifying the ten states whose corporations had the greatest combined assets. This table is based on a study of the 600 largest industrial, merchandising and utility companies in the United States. It shows that of those covered in the study, 498 were incorporated in these ten states.[52]

The modern view is, thus, securely established that a two-thirds vote of the affected class will bind the minority, as under the Model Act.

II

THE SCOPE OF JUDICIAL REVIEW TODAY

Though the old "vested rights" decisions were cast in terms of power, judges apparently were really troubled by the question of fairness of treatment. When they denied the existence of the power of a corporation to effect a proposed change on grounds that seemed technical, often they were motivated by the belief that the plan was unfair and should not be allowed, usually for the reason that management was apparently dominated by a cohesive majority group that was attempting to cut down the rights of a senior class or a minority of the same class without sufficient

The Boston and Maine plan for the disposition of preferred arrears was first turned down by the Commission and then, on a more vigorous presentation, approved. Boston and Maine R.R. Securities Modification, 282 I.C.C. 750 (1953). The Missouri-Kansas-Texas Railroad has not yet succeeded. Its first plan was rejected by the Commission. Missouri-Kansas-Texas R.R. Securities Modification, 275 I.C.C. 499 (1950). It then submitted a second plan on Dec. 24, 1952. I.C.C. Finance Docket No. 18006. This plan was amended on Jan. 25, 1955, in an unsuccessful attempt to meet the Commission's objections. The second plan was then withdrawn. (Order unreported.) A third proposal was then filed on May 1, 1957, In the Matter of the Application of the Missouri-Kansas-Texas R.R. Co., I.C.C., Finance Docket No. 19760, and an examiner's report has recommended that it be approved with modifications. The N.Y. Times, Nov. 1, 1957, p. 39, col. 4-5.

[52] Compiled by James F. Spoerri from the supplement edition Fortune of July 1956, in JOINT COMM. TO STUDY REVISION OF CORPORATE LAWS, INTERIM REPORT 61 (New York Legislative Document No. 17, 1957).

TABLE E

CORPORATE BUSINESS

State	No. of Corporations	Assets (in millions)
1. Delaware	202	$55,424
2. New York	85	40,991
3. New Jersey	45	22,768
4. Pennsylvania	45	11,659
5. Ohio	36	7,859
6. Illinois	29	6,402
7. California	13	4,864
8. Maryland	18	3,777
9. Indiana	11	3,528
10. Virginia	14	2,476

compensation or necessity. There are some opinions, indeed, that expressly went on grounds of fairness.[53]

But "fairness" is an elusive standard. Where the statutory power exists, there is no clear and certain test by which the chancellor can allow its exercise for some purposes and disallow its exercise for others. The quest for "fairness" also leads the chancellor into new fields where he is normally not expert. It places on him the heavy burden of solving complex economic problems in order to formulate a judgment as to the soundness, and hence the fairness, of the proposed amendment. The efforts to apply a deliberate test of "fairness" were, thus, gradually abandoned. They finally disappeared with the "vested rights" doctrine. It is now recognized that where the legal power for a recapitalization exists, the question of fairness is not one for judicial examination:

> The fairness or unfairness of corporate action may not be considered where that action is in exercise of a power conferred upon the corporation by the Act under which it was organized.[54]
>
> . . . .
>
> . . . the minority shareholder may not obtain relief in equity where his claim is based upon unfairness rather than fraud.[55]

Does it follow that no judicial review is permissible? By no means. Unfairness

[53] *E.g.*, Kamena v. Janssen Dairy Corp., 133 N.J. Eq. 214, 31 A.2d 200 (Ch. 1943), *aff'd per curiam*, 134 N.J. Eq. 359, 35 A.2d 894 (Ct. Err. & App. 1944). And see Wessel v. Guantanamo Sugar Co., 134 N.J. Eq. 271, 35 A.2d 215 (Ch. 1944), *aff'd sub nom.* Murphy v. Guantanamo Sugar Co., 135 N.J. Eq. 506, 39 A.2d 431 (Ct. Err. & App. 1944).

[54] Franzblau v. Capital Securities Co., 2 N.J. Super. 517, 528, 64 A.2d 644, 649 (Ch. 1949).

[55] Matteson v. Ziebarth, 40 Wash.2d 286, 297, 242 P.2d 1025, 1033 (1952). See also Dratz v. Occidental Hotel Co., 325 Mich. 699, 39 N.W.2d 341 (1949); Liebold v. Inland S.S. Co., 82 F.2d 351 (7th Cir. 1936); Katz v. R. Hoe & Co., 199 Misc. 459, 103 N.Y.S.2d 106 (Sup. Ct. 1950); Maddock v. Vorclone Corp., 17 Del. Ch. 39, 147 Atl. 255 (Ch. 1929); Barrett v. Denver Tramway Corp., 53 F. Supp. 198, 201 (D. Del. 1944), 146 F.2d 701, 706 (3d Cir. 1944); Baker v. Standard Lime & Stone Co., 203 Md. 270, 100 A.2d 822 (1953); Hyman v. Velsicol Corp., 342 Ill. App. 489, 97 N.E.2d 122 (1951); BALLANTINE, *op. cit. supra* note 43, at 656.

is very different from fraud. Fairness raises a question of judgment, where opinions may differ endlessly, and the average businessman is not particularly equipped to know what someone else might conclude at a later date with further evidence. But fraud raises a question of conscience, where the average businessman is likely to recognize that something is shocking and ought to be illegal, whenever it might be reviewed by a court and whatever might be the further evidence. Such a test is sufficiently definite to be practical, though sufficiently elastic to evolve with changing circumstances. It is in sharp contrast with the roving judgment contemplated by the "fairness" test in reorganization legislation.

Where fraud is alleged, all of the new corporation codes contemplate that the courts shall have jurisdiction, on timely application, to prevent the consummation of a plan. In some statutes, this is express.[56] In the Model Act and similar legislation, it is equally presupposed.

Where the interests of so many people are involved and the securities are traded on the exchanges, there is an unusually urgent need for prompt action on the part of anyone seeking to prevent the accomplishment of a plan. In the case of most listed securities, a stockholder will have received notice some three or four weeks before the meeting and should know that in the ordinary course, the amendment will be presented for effectuation immediately upon the conclusion of the meeting. Once the plan has been put into effect, it becomes virtually impossible to turn back the clock without hurting the innocent as well as the guilty. For this reason, the doctrines of laches and estoppel should be applied with especial strictness. Those who have reason to object and know it but do not speak seasonably should not be heard subsequently. Ordinarily, this should mean action before the issuance of the amendment.

What then is fraud? There is no definition in the statutes. That is left, and rightly so, to the equity judges, who have always used it as a flexible means of preventing a wrong of such nature as to shock the conscience. Whatever the changing circumstances may be, the equitable doctrine of fraud will be available, though it remains to be formulated by actual decisions as controversies take shape. This necessary and unavoidable imprecision, however, makes it a dangerous weapon, and one that judges should use with great restraint. In the past, the term has acquired reasonably identifiable boundaries. When applied to determine the legality of changes in corporations, it should be kept within these limits. A few things would, thus, seem expectable.

Manifestly, "fraud" should not be used as a means of nullifying the recently-enacted statutes. It cannot be found in a modification, as such, of a class shareholder's rights that is in terms permitted by the statute. To take an extreme case, a total cancellation of accrued unpaid dividends on preferred stock is one of the changes specifically authorized in the Model Act and most of the recent statutes. It

[56] See, *e.g.*, VA. CODE ANN. § 13.1-125 (Supp. 1956), restricting all review of Corporation Commission action to direct appeal, "except for fraud."

should not be possible for the courts to hold such an amendment, in and of itself, fraudulent, since it is not in their province to substitute their view of public policy for the one adopted by the legislature.[57] An exception might well exist, as indicated below, if the particular circumstances were such as to disqualify the vote as an authentic expression of class assent. But it is to be remembered that however the concept of fraud may evolve, it is still something different from unfairness. Since the pattern of recent legislation deliberately withholds court review for unfairness, the judges should be vigilant to see that they do not actually exercise such a jurisdiction under the name of "constructive fraud" or other vague metaphors of the fraud idea.

Affirmatively, it can be said with some confidence that as judges are accustomed to look with greatest favor on equality as a touchstone of equity, so inequality of treatment among members of the same class is the plainest badge of fraud. As long ago as 1919, the Southern Pacific Company, upon the reorganization of an indirect subsidiary, caused the accomplishment of a plan by which the minority stockholders could obtain shares in the new company only upon paying an assessment of $71.40 per share, while the Southern Pacific was allotted all the stock in the new company for an assessment of no more than $26 per share plus a guarantee in respect to the new bonds and an underwriting commitment in respect to all the shares. The court sustained a subsequent complaint by minority shareholders as to the allocation of the new stock. It said that when a majority (here a single company) exercises control, "it occupies a fiduciary relation toward the minority,"[58] and thus concluded that[59]

> . . . the minority may not be excluded from a fair participation in the fruits of the sale.... The wrong lay not in acquiring the [new] stock, but in refusing to make a pro rata distribution on equal terms among the old . . . shareholders.

This principle applies equally where shareholders seek a preference before creditors.[60] It applies also to beneficial incidents of the stockholder interest, even though not strictly a part of the assets held by the corporation, as where two preferred stockholders, the only ones to attack a reorganization plan, purported to appeal for the common benefit of their class and then, after the expiration of the appeal period, settled for a substantial payment. What the appellants received "in excess of their own interest as stockholders was not payment for anything they owned," but rather for settlement of litigation affecting equally all other preferred stockholders, from which it follows that the "fruit properly belongs to all."[61] They were compelled, therefore, to make a pro rata contribution to all the other holders of the same class. For similar reasons, it has been held that preferential treatment for certain stockholders to induce their assent to a merger would constitute fraud justi-

[57] Bedinger v. Graybill's Executor & Trustee, 302 S.W.2d 594 (Ky. 1957).
[58] Southern Pacific Co. v. Bogert, 250 U.S. 483 (1919).
[59] *Id.* at 487-88, 492.
[60] Pepper v. Litton, 308 U.S. 295, 306-12 (1939).
[61] Young v. Higbee Co., 324 U.S. 204, 213-14 (1945).

fying an injunction against the merger, unless the treatment were made available equally to all.[62]

This fundamental principle of equal treatment for all members of the same class is related to a further principle against duality of interest. The simplest case is to suppose that the owner of all the common stock is also the owner of two-thirds of the preferred and, thus, assents to an amendment canceling preferred arrears without any compensation. Whatever he gives up in his capacity as a preferred shareholder comes to him as the common shareholder—not only that, indeed, but also what the other preferred shareholders lose as well. Here is a conflicting motive, extrinsic and contrary to the expectable interests of the preferred as a separate class, that, as anticipated in the reference above, invalidates the class vote as an authentic expression of class choice and, thus, makes inoperative the prime safeguard afforded by the statute.

It is plain that a director is a fiduciary for the corporation and its stockholders.[63] Majority stockholders are not, by mere reason of their holdings, automatically trustees and, indeed, ordinarily remain free to vote their shares in any way they may wish.[64] But they may be made to share the fiduciary responsibilities of directors where the directors are put in office by them, especially if acting as a cohesive group.[65] If so, duality of interest, by one or the other, leads quickly to fraud.

A suggestive and arguable illustration is supplied in the attempt of the Seagrave Corporation to acquire a subsidiary from another corporation. There were seven directors of Seagrave. Of these, four had been put in office by a small group of controlling stockholders for whom the plan provided an option of selling their shares to the dominant stockholder of the selling corporation at a premium of one-third above the current market. This preferential option was not available to the Seagrave's minority shareholders. The other three directors were top management officers, who were in danger of losing their positions under the present control, but who were assured of continuation in office by the dominant stockholder of the selling corporation, who was, through these arrangements, simultaneously acquiring control of Seagrave. This was, indeed, a cloudy picture.

On attack by a minority stockholder of Seagrave, a district court enjoined the plan on the ground that each group of directors had a substantial personal interest of conflicting nature which precluded an exercise of independent judgment on the merits of the plan.[66] An appeal by Seagrave was very nearly successful on the ground that the proxy statement made a full disclosure of the preferential option and also of the inclination of the new owners to continue top management. Agree-

[62] Matteson v. Ziebarth, 40 Wash.2d 286, 297, 242 P.2d 1025, 1033 (1952).

[63] Pepper v. Litton, 308 U.S. 295, 306 (1939).

[64] Baker v. Standard Limestone & Stone Co., 203 Md. 284, 285, 100 A.2d 822, 829 (1953).

[65] Lebold v. Inland S.S. Co., 82 F.2d 351, 353-54 (7th Cir. 1936); Pepper v. Litton, 308 U.S. 295, 306 (1939). In close corporations, the personal relationships between stockholders may involve special elements of trust and confidence, and in such cases, a fiduciary relation is easier to establish. Helms v. Duckworth, 249 F.2d 482 (D.C. Cir. 1957).

[66] Mount v. Seagrave Corp., 112 F. Supp. 330 (S.D. Ohio 1953).

ing also that the economic fairness of the plan was not open to judicial examination and that the terms of the plan were not so oppressive that they could be called fraudulent in themselves, the court of appeals, nevertheless, affirmed on the ground that the personal interests of the directors at stake "deprived the stockholders of that impartial, unprejudiced action which the fiduciary relationship required."[67] Calling this "constructive fraud," the court affirmed the injunction.

This case emphasizes the statutory function of the directors in making the initial proposal of the plan to the shareholders. That submission undoubtedly involves the responsibility of recommendation, even though the words of the Model Act do not require anything except the adoption of a resolution "setting forth the proposed amendment" for submission at a meeting of the shareholders.[68] And some states have spelled out this inferential responsibility of recommendation in their statutes. Thus, Virginia requires that the resolution be one "setting forth the proposed amendment, finding that it is in the best interest of the corporation and directing that it be submitted. . . ."[69]

In the *Seagrave* case, however, since the only two elements of conflicting interest, the premium and the employment, were clearly shown in the proxy statement, the case is an extreme one and merits criticism. Other courts would have decided the other way.[70] As a general rule, that seems the right course, because the full disclosure gives a substantial minority of the stockholders the power to reject the plan. There seems no public policy for denying the owners the right to assent, if they choose to do so with full notice. With regard to the inequality of treatment, which was the basic ground of the decision, the court, at most, could have conditioned its injunction on refusal to open up the preferential offer in such a way as to make it equally available to the minority. But, it should be recognized that this is a jurisdiction to be sparingly exercised, since it means that the court is making a new bargain in lieu of what the principals have accepted. With regard to the dual interest of the three directors, which was a secondary ground for the decision, the court's decision is shortsighted, in that it may make any action impossible in particular situations, and improvident, in that it pays no heed to the possible benefits of the plan. The minority might well have been better off with the plan than without it, even though not quite so well off as the majority. They may not be benefited by setting the whole plan aside, even though a particular litigant might benefit in a tactical sense. Salving the conscience of the court or vindicating the theoretical correctness of a single shareholder's objection is not as important as protecting the general interests of the shareholders, the corporation, and the public.

Where there is a conflicting interest of such substantial nature and effect as to negate the statutory process of director recommendation and class assent, the appropriate remedy is to put the proponents on proof that the plan is fair. This is the

[67] Seagrave Corp. v. Mount, 212 F.2d 389, 393 (6th Cir. 1954).
[68] MODEL BUSINESS CORPORATION ACT § 54.
[69] VA. CODE ANN. § 13.1-56 (Supp. 1956).
[70] See Matteson v. Ziebarth, 40 Wash.2d 286, 242 P.2d 1025 (1952).

rule applied by some courts in similar situations where directors have other interest.[71] It has special applicability in cases where the plan itself involves a conflicting interest of directors or, more importantly, of shareholders. This has been recognized:[72]

Plaintiffs invoke the settled rule of law that Hilton as a majority stockholder of Mayflower and the Hilton directors as its nominees occupy, in relation to the minority, a fiduciary position in dealing with Mayflower's property. Since they stand on both sides of the transaction, they bear the burden of establishing its entire fairness, and it must pass the test of careful scrutiny by the courts.

Such proof would normally follow the general pattern of the reorganization cases. First, that there is some corporate need for the recapitalization and that the particular plan is feasible. Second, that the treatment accorded the respective classes is fair. This requires the court to weigh the investment attributes of the old stock according to their probable realization in the light of reasonably foreseeable future earnings, and hence to appraise "the current worth of [the] promise"[73] or its "investment value."[74] This is to be compared with the prospective economic or investment worth, similarly ascertained, of the differing attributes of the new securities or other consideration proposed. No dollar figures are necessary as to the old and the new.[75] Rather, a judgment conclusion is contemplated to the general effect that the new treatment will represent "the equitable equivalent"[76] of the old or its "economic equivalent."[77] This is not to be ascertained on a spot-cash basis, but on the basis of the prospective future that has such a degree of likelihood within such an expectable period of time as normally to merit recognition by a reasonable investor. In all this field, there are legal standards to apply, but the material and the measures for weighing it are financial and economic in nature.

The occasions for judicial review of the elements of fraud that have been so far mentioned may now be summarized in classical, though necessarily general, words of the Supreme Court. It said that judicial review begins where legal power is exceeded or "a fraudulent transaction" is theatened and, thus, by way of illustration:[78]

. . . where the board of directors, or a majority of them, are acting for their own interest, in a manner destructive of the corporation itself, or of the rights of the other shareholders; . . .

Or where the majority of the shareholders themselves are oppressively and illegally pursuing a course in the name of the corporation, which is in violation of the rights of the other shareholders, and which can only be restrained by the aid of a court of equity.

[71] *E.g.*, Fountain v. Oreck's, Inc., 245 Minn. 202; 71 N.W.2d 646 (1955).

[72] Sterling v. Mayflower Hotel Corp., 33 Del. Ch. 293, 298, 314, 93 A.2d 107, 110, 119 (Ch. 1952).

[73] Schwabacher v. United States, 334 U.S. 182, 199 (1948).

[74] In the Matter of Green River Steel Corp., Corp. Reorg. Release No. 105, Jan. 24, 1957, p. 21.

[75] Group of Institutional Investors v. Chicago, M., St.P. & Pac. R. Co., 328 U.S. 523, 565-66 (1943).

[76] *Ibid.*

[77] Schwabacher v. United States, 334 U.S. 182, 200 (1948).

[78] Swanson v. Traer, 354 U.S. 114, 117 (1957), quoting from Hawes v. Oakland, 104 U.S. 450, 460 (1881).

The next element that will be given greatest weight in shifting a question of fraud is the sufficiency and fullness of the information given to stockholders. As already indicated, it would be too extreme to say that disclosure precludes the possibility of fraud. The sole owner of all the common stock and two-thirds of the preferred voting to cancel without compensation all preferred arrears for his own benefit should be held fraudulent, however boldly his purpose be preclaimed in a proxy statement. But in all cases of alleged fraud, there can be no doubt that disclosure is the strongest antiseptic. The more fully the owners are informed as to the meaning and consequences of their choice, the more meaningful is their vote as an authentic expression of ownership preference and, thus, the fuller the satisfaction of the statutory policy. At the same time, the fuller is the protection that will be accorded management. The basic importance of adequate information is recognized in the stock exchanges:[79]

> Shareowners must be assured of *adequate and timely information* on which to base their vote—and in a larger sense—on which to base their investment decisions.

Where no proxy statement is required by the governing statute, the mere requirement of notice of the meeting is not to be read so broadly as to have the same effect. It means notice in the classical sense, and no more. But this means only that a meeting will not be held invalid for lack of notice where the meager notice of classical proportions has been given. If any substantial question of fraud arises, a wholly different standard comes into play at once, and an adequate exposition of the nature and effect of the change may well be required not to satisfy the statutory standard, but to repel the charge of fraud.

Turning now from interpretation to policy, it is desirable that legislation go on further to require this same degree of information from the business managers in any proposal for recapitalization. The affairs of corporations have become so technical and so remote from the usual shareholder that there is increasing need for proxy statements that clearly reveal the substance of the proposal. Where there is no such requirement, one should be supplied. Suitable information is required by the Securities and Exchange Commission with respect to all securities listed on a national securities exchange.[80] Its administration of that law, as of the Securities Act of 1933,[81] has undoubtedly been a great national benefit. But there are many other corporations of general investment interest that have no securities listed on a national securities exchange and, thus, are not subject to the Proxy Regulation. Bills have been pending unsuccessfully in the Congress since 1949 to extend the proxy power of the Securities and Exchange Commission over unlisted securities. If confined to corporations of sufficient size, this is a meritorious proposal that

[79] Funston, *supra* note 33, at 4.

[80] Securities Exchange Act § 14, 48 STAT. 895 (1934), 15 U.S.C. § 78n (1952); SEC Regulation X-14.

[81] 48 STAT. 74, 15 U.S.C. §§ 77a-aa (1952).

should be enacted. The latest bill, as introduced by Senator Fulbright,[82] would have applied to every issuer with total assets exceeding $2,000,000, where its equity securities are held of record by more than 750 persons. The studies of the Securities and Exchange Commission indicate that in this form, the bill would have applied to approximately 1,200 corporations with assets aggregating $35,000,000,000.[83] As reported out by the Committee, the bill is confined to corporations with at least $10,000,000 of assets and 1,000 shareholders. As so amended, the bill would reach approximately 600 unlisted companies and assure all their stockholders of the substantial, pertinent, and timely information that has resulted from the Commission's healthy administration of section fourteen of the Securities Exchange Act[84] with respect to listed companies. There can be no doubt that when a corporation reaches this size and involves this many people, it becomes a matter of general consequence, rather than of a purely local interest. It is also clear that with the increasing importance given class voting in modifications of class shareholder rights, adequate information on the nature and effect of the plan grows in public importance. The requirements of the Proxy Regulation are enforceable by judicial review and injunction before the meeting.[85]

A more extreme proposal has also been under consideration by the Securities and Exchange Commission involving the repeal of its Rule 133. Since the original enactment of the Securities Act of 1933, it has been generally understood that modifications of shareholder rights through voting procedures sanctioned by state statute, like amendments and mergers, were not "sales" within the terms of the Act. This basic conclusion as to the interrelation of federal and state legislation has not had official standing in proportion to its importance. Though covering the field of Securities and Exchange Commission responsibilities, it was originally embodied only in an instruction to Form E, applicable to issues of securities in certain forms of reorganization. This was applied in most situations, however, though not with absolute uniformity. When Form E was repealed, the rule was not recorded anywhere and remained only as an unwritten tradition that was respected in the administration of the 1933 Act. In the course of the admirable revisions recently made by the Commission to systematize all its rules and put of record all traditional practices, Rule 133 was adopted as a precise and official statement of this practice.

[82] S. 1168, 85th Cong., 1st Sess. (1957), introduced Feb. 11, 1957. See also, *Hearings before a Subcommittee of the Committee on Banking and Currency of the Senate on S. 594, S. 1168, and S. 1601*, 85th Cong., 1st Sess. (1957); SEC, *Report on S. 2054 to the Committee on Banking and Currency of the Senate*, 84th Cong., 2d Sess. (1956); SEC, *Supplementary Report on S. 2054 to the Committee on Banking and Currency of the Senate*, 85th Cong., 1st Sess. (1957); Meeker, *Current Trends in the Federal Securities Laws*, 12 THE RECORD 347, 360 (1957); Meeker, *Current Proposals to Amend the Federal Securities Laws*, 13 BUSINESS LAWYER 379, 386-87 (1958).

[83] Testimony of J. Sinclair Armstrong on May 20, 1957, *Hearings, supra* note 82, at 10-37.

[84] 48 STAT. 895 (1934), 15 U.S.C. § 78 n (1952).

[85] SEC v. May, 134 F. Supp. 247 (S.D.N.Y. 1955), *aff'd*, 229 F.2d 123 (2d Cir. 1956); SEC v. Okin, 58 F. Supp. 20 (S.D.N.Y. 1944); SEC v. O'Hara Re-Election Comm., 28 F. Supp. 523 (D. Mass. 1939). *Cf.* SEC v. Transamerica Corp., 67 F. Supp. 326 (D. Del. 1946); *modified on other grounds*, 163 F.2d 511 (3d Cir. 1947), *cert. denied*, 332 U.S. 847 (1948). *But cf.* Howard v. Furst, 140 F. Supp. 507 (S.D.N.Y. 1956), 238 F.2d 790 (2d Cir. 1956), *cert. denied*, 353 U.S. 937 (1957).

The recent proposal for its early repeal is primarily designed to make the registration provisions of the 1933 Act applicable to mergers and amendments, since the Commission feels that secondary distributions have occurred in connection with some mergers contrary to the registration policies of the Act. But the proposed remedy is far wider than the evil. It would give most recapitalizations the legal status of sales, even though no new investment is to be made by the shareholder. Such widespread opposition developed,[86] that the Commission has deferred any formal action on Rule 133 pending further study and has announced that it would deal with distributions that appear to violate the registration policies of the Act on a case-by-case basis.[87]

III

THE RESULTING RESPONSIBILITIES

When recapitalizations are needed, management plays a crucial role in crystallizing the will of the owners. As steward for the absentee owners, it is for management to formulate a plan. This usually requires negotiation with underwriters, or institutional purchasers, or other corporations that may be included in a unification. The initial choice of approach, differently affecting the interests of shareholders, is largely irrevocable once made, because a negotiation, however fluid, seldom flows backward. At each stage of the formulation of the plan, new responsibilities for fair treatment of all interests rest on management as a result of the semifinal effect of shareholder choice under modern legislation. New responsibilities for full and fair disclosure also result directly from this same circumstance, for the vote of the owners is meaningful as an expression of their real desire only if they are adequately informed.

There are massive sanctions to enforce these new responsibilities, though for the most part, they are beyond the process of a court and not utilizable in ordinary litigation. True enough, at the technical level, disclosure is the most powerful defense against a claim of fraud. Many things that would be fraudulent if unsaid are not when explained, and the informed choice of a statutory majority will bind all conclusively. The things that would remain fraudulent even though fully ex-

[86] See SEC, REPORT OF PROCEEDINGS ON PROPOSED REVISION OF RULE 133 UNDER THE SECURITIES ACT OF 1933 app. 9, at 11-12, 17-20, 44, 47, 93, 120 (1957).

[87] Securities Act Release No. 3761, March 19, 1957; Demmler, *Developments in Federal Regulation Securities*, 12 BUSINESS LAWYER 470, 476 (1957). Where the new securities are acquired with a view to distribution, the Commission has asserted that the exemption is unavailable. Securities Act Release No. 3846, Oct. 10, 1957, although it may be observed that this presupposes a "purchase" from the issuer, despite the fact that by Rule 133 there has been no "sale." See Orrick, *Some Interpretative Problems Respecting the Registration Requirements under the Securities Act*, 13 BUSINESS LAWYER 369 (1958).

There is an important difference where the securityholder is already invested in the venture. Thus, the British Companies Act, 1948, 11 and 12 GEO. 6, c. 38, §38, specifying the contents of a prospectus, has no application to a pro rata offering of new shares to existing shareholders. Cole, Morley, and Scott, *Corporate Financing in Great Britain*, 12 BUSINESS LAWYER 324, 356-59 (1957). In the case of a reclassification, not only has the shareholder already invested, but he is also not asked to supply additional capital, though admittedly his rights are being changed in substance and the proxy requirements are, therefore, particularly salutary. For arguments favoring repeal of Rule 133, see Sargent, *A Review of the No-Sale Theory of Rule 133*, 13 BUSINESS LAWYER 78 (1957); for arguments opposing, see Throop, *In Defense of Rule 133*, 13 BUSINESS LAWYER 389 (1958).

plained are very few and exceptional. So also, fairness in the substance of the plan has an eventual relation to reviewability: when it passes the point of a difference of judgment and becomes shocking to the conscience of the chancellor, it is at the door of fraud. But the principal sanctions lie further on.

At a deeper level, management impairs its standing with the shareholders when it proposes an unfair plan or proposes any plan without adequately disclosing its nature and effect. Either course is a perilous development for all concerned. As for the stockholders, since they must look to management for the direction of operations and the development of any necessary recapitalization plans, they must either sell their stock, or go to the trouble of protesting, or take steps to throw management out of office. As for management, the loss of shareholder trust and confidence terminates their satisfaction in supervising the corporate affairs and, at a further degree, may terminate their job as well. These consequences are not automatic. But they are likely. And some of the largest oaks fall in unexpected winds. When stockholders are restless and many shares are in temporary hands, any one who knocks loudly on the door may find himself in.

Still more fundmental is the sanction imposed by society itself. Corporations are allowed to manage their own business only if, by and large, they manage it well. They are too large and too important to have their way on any other terms. The rule that a two-thirds assent binds the whole class has come into being as the healthy and practical rule for the modern corporation. It deserves to prevail and to have the fidelity of management that will maintain it. But should abuses become prevalent, the rule will be changed. And unless the corporation continues to do a better job than government could, society will interpose to protect its essential interests.

This is not mere theorization on the familiar theme of power entailing responsibility. It represents the sensitive insight and governing motive of leading corporate managements. This was well illustrated at the latest annual meeting of Standard Oil Company of New Jersey. Here is the same company, it will be remembered, that once had pioneering days of its own and was accused of frontier manners at that time, was subsequently disintegrated under the Sherman Act,[88] and is now multiplied beyond any dream and one of our best citizens. First, as to the power of this great corporation, which goes beyond physical possessions, the chairman said:[89]

> . . . Jersey is a leading example of democratic enterprise. It strengthens the American way at home and provides an example of its benefits to our friends abroad. And because energy is an essential to defense, the company is an integral part of the shield that guards all free men from tyranny.

Then as to the responsibilities that flow from this position, the chairman said:[90]

> Jersey feels a responsibility and has a determination to maintain scientific and technical

[88] Standard Oil Co. of New Jersey v. United States, 221 U.S. 1 (1911).
[89] Standard Oil Company of New Jersey, 75th Annual Meeting 7 (1957).
[90] *Ibid.*

leadership; to prove itself a good citizen; to establish sound human relations. It believes it must live by principles of ethics and morality which form the basic rules of society; and do its part in establishing those rules of conduct in its business relations throughout the world.

Applying this philosophy to operations, the president said:[91]

. . . [N]o commercial organization, particularly one of Jersey's size, can exist without creating certain social influences and, thereby, acquiring responsibilities beyond those of a purely business nature. These responsibilities will certainly grow in the future, as Jersey's normal growth continues. . . .

Applying this to the particulars, the president gave special emphasis to the 156,000 employees and concluded:[92]

In addition, Jersey has civic responsibilities to the various communities where its affiliates operate, financial responsibilities to the educational institutions from which it draws many of its key employees, and—under many categories—responsibilities to governments.

With regard to the latter, Jersey's stature entitles it to add that these include "the responsibility to help and to participate in the development of friendly foreign nations."[93] It has, indeed, more earthly power than many formal sovereignties that sit in the United Nations.

This epitomizes the best thinking in contemporary corporate management. In this new world, the feudal "diversities" are no longer meaningful. The class shareholder rights are not fixed, but relative, and it is better in the public interest that this be so. But, without regard to the technical processes of the courts and looking to broader social necessities that are translated into legislation and judicial process whenever necessary, management has new responsibilities in consequence. Most directly these are to the shareholders as analyzed above. But that is not all. With great new size and power, there also come great new responsibilities toward all the groups who are affected by the corporate undertaking. Thus, in a very real sense, management bears a share of the responsibility for maintaining that miracle of a dynamic, expanding, and socially-respected economy that supports the American way of life.

[91] *Id.* at 14.

[92] *Id.* at 14.

[93] *Id.* at 15.

MINORITY AND DISSENTING SHAREHOLDERS' RIGHTS IN FUNDAMENTAL CHANGES

NORMAN D. LATTIN*

One necessarily starts with the principle that the corporate charter constitutes a contract not only between the corporation and its owners and between the owners themselves, but also between the corporation and the state—a principle which derives from the important *Dartmouth College* case[1] and the early cases which followed it. An element that must be read into this contract, therefore, is comprised of the pertinent constitutional and statutory provisions, one kind of which, that governing the power to alter, amend, or repeal corporate charters, created some interesting, albeit difficult, problems.

Prior to the inception of such provisions, fundamental corporate change could be effected only by the state through the exercise of its police power or, in some cases, with the unanimous consent of the shareholders or members. Since the interests of the state were thus protected in a reasonably adequate manner, the explicit reservation of the power to alter, amend, or repeal corporate charters was widely held to extend the state's authority beyond the area of policy and into that of the shareholders' contract. Most of the cases—and the better ones, too—accordingly, held that this authority was sufficiently extensive to compel changes in the shareholders' contract, either directly by statute or through a prescribed vote of shareholders authorized by statute. In either event, however, the important point ultimately established was that no longer did the federal constitutional injunction against the impairment of the obligation of contracts protect against changes made in accordance with the statutory procedure, provided the corporation either had been born after this power to alter, amend, or repeal had become effective or had accepted the new power as if incorporated into its earlier charter. There was not universal agreement, however, on such broad interpretations.

Although fundamental changes of the shareholders' contract were thus legalized, some courts took the cautious view that the statute must spell out in specific language the changes which might be made; others, on the other hand, permitted reliance upon broad, undefined language—for example, the authorization of changes which might have originally been included in the articles or certificate of incorporation.

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[1] Trustees of Dartmouth College v. Woodward, 17 U.S. (4 Wheat.) 518 (1819).

Another principle, moreover, prohibited the taking of property without due process of law, and this, too, was evoked by some courts to discourage major corporate changes. But it should be noted that as far as the shareholders' contract was concerned, each provision looked very much like other contractual provisions, and not like vested property rights of the sort that the due process clause was intended to protect—that is, unless a court were to go the whole way and call all contractual provisions vested property rights, a thing none has been willing to do. Furthermore, many constitutional rights may be waived, and, if necessary, it could be said that such a waiver was exercised when the shareholder took his shares subsequent to the insertion in constitutions and statutes of the reservation to alter, amend, or repeal corporate charters.

The course of case law in this area has, in short, been arduous and long, and the conclusions reached have not all been harmonious, but their soundness is now no longer doubted.[2]

This article will discuss generally the major corporate changes which have been analyzed as usurpations of the shareholders' contractual rights; more particularly, it will focus on the compromise solution afforded by appraisal remedies when such changes are made.

Where there is a fundamental change made in the purposes for which the corporation was organized; or where there is a sale of a substantial part or all of the assets of a corporation out of the ordinary and regular course of business; or where there is a merger or consolidation, or a change in the share contract, or a dissolution of a prosperous corporation, shareholder rights are altered or obliterated in the process. Prior to the enactment of enabling statutes, the common law, in general, did not permit such basic corporate changes without the unanimous consent of the owners and, in case of a merger or consolidation, without the consent of the state.[3] In this respect, the owners of the corporation were treated approximately as if they were partners, where the rule contemplates unanimity of action in any activity exceeding that set out in the partnership agreement.

This rule of unanimous action had some validity in the small, closely-held, corporation which, in many respects, functioned informally, as if it were a partnership, with its owners, as "employees," devoting their full time to the business, as partners quite customarily do. When the closely-held corporation became less closely held, however, so that there were owners who did not actively participate in carrying

[2] For a more extensive treatment of this difficult subject, see Lattin, *A Primer on Fundamental Corporate Changes*, 1 WESTERN RES. L. REV. 3 (1949).

[3] Professor Warren was emphatically of the opposite opinion, writing: "The general rule at common law is that (apart from some agreement of the members to the contrary) all corporate powers are vested in the members of the corporation, and that a decision of the majority as to the exercise of such power binds the minority." Warren, *Voluntary Transfers of Corporate Undertakings*, 30 HARV. L. REV. 335, 346 (1917). The traditional view, however, is contrariwise. But Professor Dodd did express the view that "even at common law it is by no means clear that the majority cannot sell all the assets of a corporation without regard to its financial condition, provided that the sale is made to a stranger and for cash." Dodd, *Dissenting Stockholders and Amendments to Corporate Charters*, 75 U. PA. L. REV. 585; *id.* at 723, 734 (1927).

on the business and who were more interested in productive investments than in keeping the family corporation within its previously established bounds, there arose the need for a more democratic approach. This involved choices which depended upon policies, which, in turn, depended upon local tradition, which, in many states, reflected the type of corporation carrying on business within its borders—either small and closely-held or larger and publicly-held. Also, and quite naturally, there was the urge, here and there, for revenue purposes, to induce businesses operating outside the state to incorporate under the local statute, as well as to encourage businesses within the state to use the local statute rather than foreign ones for corporate creation. And statutes which are "liberal" will accomplish such purposes—particularly so when they permit corporate change readily and without too great a threat of obstruction from minority owners.

In the case of a sale or exchange of assets of a corporation, particularly a successful one, there first had to be decided such questions as whether *all* sales of all or a substantial part of the corporate assets should require shareholder authorization, or whether certain distinctions should be drawn: Should a sale in ordinary course of business require more than the board's approval? Should one for a consideration other than cash—shares of stock in another or the purchasing corporation, for example—require the approval of the owners? Should a mortgage, deed of trust, or pledge of all the assets for a loan or to secure an indebtedness already assumed require more than board action? Should a sale of the assets of a going concern be treated differently from one of a failing corporation? In what cases, if any, should a dissenting shareholder be given a right to demand payment for his shares? Should the board, without the approval of the owners, be able to abandon a sale properly authorized—and, if so, upon what conditions? As might be expected, a variety of answers has been given by the statutes, but if generalizations are possible, it may be said that a sale in ordinary course of business needs no more than board action nor, by and large, does a mortgage, deed of trust, or pledge of corporate assets to secure a debt; that a sale or exchange of assets out of the ordinary and regular course of business requires shareholder action, and occasionally board action as well; and that a sale of the assets of a going concern is frequently distinguished from that of one on the brink of insolvency, the latter requiring board action alone.

Somewhat similar questions must be asked in case of a material change in the corporate purposes or in the share contract of a class of shares. Determinations must be made as to who may vote upon specific provisions; what proportionate vote is needed to carry a resolution; what preliminary steps are necessary before submitting a resolution to the shareholders; whether the shareholders, in their meeting, may significantly change the resolution submitted to them by their board; and whether the board may, without shareholder consent, abandon an authorized change. In these changes, there may also be possible dangers to the owners. Some may be willing to assume the risk; others, however, may prefer to sell out and invest in other ventures.

And so it is, too, in the case of mergers and consolidations. The shock here is great enough to warrant the conclusion that no shareholder should be required to surrender his shares for new ones in either a corporation into which his has merged or a newly organized one into which his and other companies have consolidated; nor should he be required to retain his shares in his own corporation when other companies have merged into it and new shares have been issued to others in the process. But there are still problems as to who should be permitted to vote in the matter—that is, holders of shares of whatever kind, holders of only those which have voting rights, or holders of those which have only a right to vote on the specific resolution to merge or consolidate, if such there be.

In the case of an authorization to dissolve a prosperous corporation, who may vote and what proportion may carry the resolution are, again, matters of policy. If it is to be an honest dissolution for the purpose of going out of business, and not simply to freeze out a minority group, there would seem to be no basis upon which to argue a further policy of appraisal for those dissenting. Dissolution means an end to the corporation, and, after the payment of debts and expenses, the remaining assets are distributed in accordance with the shareholders' contract and, if there are no special contracts giving preferences, then pro rata, each share being equal to every other one.

Thus, while owners should be permitted to participate in making a decision involving a material or fundamental change, choices must be made as to which owners, if less than all, should have this right; how it is to be exercised—that is, through what formalities; and how large the vote or consent must be to authorize the particular change. Policy factors will dictate whether dissenting shareholders shall have the further right of demanding payment of the value of their shares, thus giving them the right of retreat from the disadvantage or risk they feel the particular corporate alteration involves. A delicate balancing of the interests of majority and minority owners is necessary, for the majority owners should not be chained to what they believe to be unsound business judgment; yet, neither should the minority owners be bound to remain shareholders when they have similar misgivings. And whether a dissenting shareholder should be able to contest more than the validity of the vote through which the change purported to be authorized is also a question of policy which should be decided by balancing, on the one hand, the possible dangers of unlimited freedom to legislate fundamental changes through majority vote and, on the other, the power of a minority to prevent prompt action by threats of suits to enjoin changes claimed to be unauthorized or not effectuated in the prescribed manner.

An examination of the statutes discloses some interesting details from which some conclusions may be drawn. All states require shareholder approval of mergers and consolidations; and the forty-six states and the District of Columbia having appraisal provisions sanction the corporate purchase of dissenting owners' shares, at the owners'

option.[4] Ignoring the exceptions in which a shareholder vote is not required, forty-four states and the District of Columbia specifically permit the sale, lease, or exchange of all or a substantial part of a corporation's assets, when authorized by the shareholders;[5] but in fifteen of these, there is no appraisal provision which permits a dissenter to withdraw and be paid off.[6] This is somewhat surprising, as many of these jurisdictions specifically permit an exchange or barter of assets and the payment in shares of the purchasing or some other corporation. The fact that twenty-nine states do afford appraisal rights under such circumstances, however, indicates that the policy of protecting the dissenter in this way is rather well-intrenched.

Although shareholder approval is needed where substantial changes are made in the purpose clause of the articles or certificate of incorporation, there are very few statutes which permit the shareholder the election of withdrawing by requiring the corporation to purchase his shares.[7] This may reasonably be attributed to the not too wholesome custom of drafting the purpose clause broadly enough to include practically any business which the board determines will be profitable to the owners. Hence, shareholders are led to expect change. And there seems to be no doubt that the hunt for diversification of products, thought to be so necessary to business success today, has also had its influence.

While the shareholder is usually given the right to vote upon material changes in his contract that adversely affect or may affect his class of shares, even though he may not be permitted to vote in other situations, there are surprisingly few statutes that give him the additional right of withdrawing, if he so elects, by requiring the corporation to purchase his shares.[8] The weighty policy considerations that warrant appraisal in the case of a merger or consolidation and in the case of a sale, lease, or exchange of all or substantially all of the corporate assets that are lacking in the case of a material change in the shareholder's contract, however, are not im-

[4] There are no specific statutory provisions in Utah and West Virginia.

[5] There are no specific statutory provisions in Arizona, Iowa, Mississippi, and Wyoming.

[6] Appraisal provisions to a full or lesser extent in the case of a sale, lease, or exchange of assets exist in Connecticut, Idaho, Illinois, Indiana, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Missouri, Montana, New Hampshire, New Jersey, New Mexico, New York, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Rhode Island, South Carolina, Tennessee, Texas, Vermont, Virginia, Washington, and Wisconsin. MODEL BUSINESS CORPORATION ACT § 74 also permits appraisal in the case of sales in other than the ordinary course of business.

[7] These statutes permit appraisal in such cases: LA. REV. STAT. § 12:52 (1950); MASS. GEN. LAWS c. 156, § 46 (1932), as amended by Mass. Laws 1943, c. 38, § 2; MINN. STAT. § 301.40 (1953); OHIO REV. CODE ANN. § 1701.74 (Page Supp. 1956) (the articles may take this right away); OKLA. STAT. tit. 18, § 1.157 (1951), and see also *id.* § 1.158; TEX. BUS. CORP. ACT art. 5.11 (1956); VT. STAT. § 5821 (1947); WASH. REV. CODE § 23.16.140 (1951).

[8] These statutes permit appraisal in such cases: LA. REV. STAT. § 12.52 (1950); MO. REV. STAT. § 351.090(4) (1949) (a limited right); N.Y. STOCK CORP. LAW § 38.11; N.C. GEN. STAT. §§ 55-113, 55-101(b) (Supp. 1955); OHIO REV. CODE § 1701.74 (Page Supp. 1956) (requires "substantial" prejudice to shares of a class "where the articles do not expressly or by implication provide for or permit such amendment"); OKLA. STAT. tit. 18, § 1.157 (1951), and see also *id.* § 1.158; PA. STAT. ANN. tit. 15, § 2852-810 (Supp. 1956) (where a pre-emptive right is taken away); WASH. REV. CODE § 23.16.140 (1951); MD. ANN. CODE art. 23, § 69(a)(3) (1951), as amended by Md. Laws 1933, c. 405, referring to art. 23, § 10 (for encroachment on shareholders' contract rights when the charter does not reserve the right to make the particular amendment).

mediately clear. If the share's dividend rate, redemption price, par value, dissolution preference, and a host of other preferences may be changed to the disadvantage of the shareholder, the policy of giving him an appraisal right would seem to be highly reasonable. His contract, changeable as a chameleon, has none of the protection which changeable hues afford this little reptile. On the other hand, such changes in his contract are normally not made unless economic conditions demand them; and, if the stated majority of his class votes in favor of them, together with the stated majority of other classes of shares outstanding, it is arguable that economic necessity overbalances the personal right which appraisal provisions would create. His plight certainly is no worse than that of his fellow shareowners who have voted to give themselves something less than that to which their contract entitled them.

Important also in a determination of whether appraisal rights should be narrowly confined or broadly granted are the equitable limitations which bind controlling owners in the exercise of their powers. Thus, when voting power is sufficient to authorize a fundamental change, it must be used with fairness and without favoritism to any shareholder or shareholding group. Controlling shareholders have a legal duty to procure a fair price in a sale of corporate assets, fair terms upon a merger or consolidation, and equal treatment upon a dissolution when they so legislate.[9] When those in control act, they have a fiduciary obligation to the remainder to act with fairness, a sort of civil due process in corporate government.[10] And prompt attack may be the means of restraining majority action falling short of these standards.

It necessarily follows, therefore, that when a stated majority acts in areas where the dissenting shareholder may claim an appraisal right, the dissenter must be given a fair opportunity to participate with the majority in a plan which has been conceived in the light of these principles of equitable limitation. Otherwise, he will be forced to seek appraisal, for he has no real choice.[11] If a stated majority has used one authorized device to reach a result authorized by another device, perhaps to avoid the appraisal right—as, for example, where the sale-of-assets provision is used to effect a merger or consolidation; or where the dissolution provision is used not for going out of business, but to oust some of the owners so that the remainder may carry on under a new corporate or other business organization flag—another

[9] Outwater v. Public Service Corp. of New Jersey, 103 N.J.Eq. 461, 143 Atl. 729 (Ch. 1928), *aff'd,* 104 N.J.Eq. 490, 146 Atl. 916 (Ct. Err. & App. 1929). See dictum in Allied Chemical & Dye Corp. v. Steel & Tube Co. of America, 14 Del. Ch. 1, 18, 120 Atl. 486 (Ch. 1923); Allaun v. Consolidated Oil Co., 16 Del. Ch. 318, 147 Atl. 257 (Ch. 1929). *Cf.* Wall v. Anaconda Copper Mining Co., 216 Fed. 242, 243, 246 (D. Mont. 1914). An illuminating recent case on the valuation of assets upon a sale is Baron v. Pressed Metals of America, Inc., 117 A.2d 357 (Del. Ch. 1955), *motion for reargument denied,* 118 A.2d 360 (Del.Ch. 1955), *aff'd,* 123 A.2d 848 (Del. Sup. Ct. 1956).

[10] "Unless the majority in such case are to be regarded as owing a duty to the minority such as is owed by the directors to all, then the minority are in a situation that exposes them to the grossest frauds and subjects them to most outrageous wrongs." Allied Chemical & Dye Corp. v. Steel & Tube Co. of America, 14 Del.Ch. 1, 12-13, 120 Atl. 486, 491 (Ch. 1923).

[11] See Colgate v. U.S. Leather Co., 73 N.J.Eq. 72, 98, 67 Atl. 657, 668 (Ch. 1907). The recent North Carolina statute, however, specifically recognizes the possibility of other rights "in law or equity." N.C. GEN. STAT. § 55-113(b) (Supp. 1955), and see *infra* note 48.

simple rule comes into play: One authorized device may not be used to accomplish a result within the purview of another authorized device or to reach a result not yet sanctioned.[12] Thus, the common law has worked out some reasonable limitations upon the exercise of power in corporate government as it relates to the owners of the corporation, limitations to which legislatures should be sensitive when requested to simplify majority action by relegating dissenters to an appraisal of their shares when it appears that the statutorily-prescribed majority has approved or consented to the change.[13] While reasonable freedom of action by the majority owners is desirable, dictatorship is just around the bend when minorities are left but one choice, and that one through the appraisal route. It would, indeed, be unfortunate if the legislative cure for minority obstruction should be the means of obliterating a century of common law which has been striving to put honorable business practices into corporate profit-making and sharing.

[12] Thus, in Ervin v. Oregon Ry. & Navigation Co., 27 Fed. 625 (S.D.N.Y. 1886), the court condemned the use of a dissolution provision to effect a consolidation and virtual reorganization, without giving minority interests the opportunity to participate; in the process, the corporate assets had actually been sold by the majority to themselves for an inadequate price. Similarly, in Meyerhoff v. Bankers' Securities, Inc., 105 N.J.Eq. 76, 147 Atl. 105 (Ch. 1929), where a sale-of-all-assets section had been projected as a means to be used to bring about a dissolution, the court required compliance with the dissolution section. And in Finch v. Warrior Cement Corp., 16 Del.Ch. 44, 141 Atl. 54 (Ch. 1928), where the sale-of-assets section was to be used to accomplish a reorganization and stock was to be taken as the purchase price and distributed to the shareholders rather than to the selling company, the court held that if the majority insisted upon a sale as the method of reorganizing the company's affairs, the minority was entitled to insist that it be a sale and not a merger, which legally it would be. So, too, in William B. Riker & Sons Co. v. United Drug Co., 79 N.J.Eq. 580, 82 Atl. 930 (Ct. Err. & App. 1912), where the dissolution section had been used to effect a consolidation with a foreign corporation, the court held that there must be a bona fide dissolution intended to end the corporate life; otherwise, there would be a "fraud upon the statute." And in accord is Doe Run Lead Co. v. Maynard, 283 Mo. 646, 223 S.W. 600 (1920). And, again, in Theis v. Spokane Falls Gas Light Co., 34 Wash. 23, 74 Pac. 1004 (1904), the court balked the use of the dissolution device to oust an obstreperous shareholder who would not sell his shares and the formation of a new company by the majority to take over the operation. For a more thorough treatment, see Lattin, *Equitable Limitations on Statutory or Charter Powers Given to Majority Stockholders*, 30 MICH. L. REV. 645 (1932). An interesting provision which the draftsmen must have designed to accomplish one result through the use of a device calling for a smaller proportionate shareholder vote is contained in N.C. GEN. STAT. § 55-108(b) (Supp. 1955). This is a very wise provision.

[13] *But see* Porter v. C. O. Porter Mach. Co., 336 Mich. 437, 58 N.W.2d 135 (1953), noted in 52 MICH. L. REV. 451 (1954), where there was a sale of all the assets for shares in a corporation organized for the purpose of buying the assets in order to continue the life of the corporation another thirty years. The constitution required a shareholders' vote to renew the corporate life for another thirty years, and the necessary two-thirds vote could not be obtained; but a sufficient number could agree on a sale of assets, which required a majority vote. See also CAL. CORP. CODE § 4123, which makes the appraisal right the sole remedy, but which permits the shareholder to "test whether the number of shares required by statute to authorize or approve the merger or consolidation have been voted in favor thereof by persons legally entitled to vote them . . ."; Beechwood Securities Corp. v. Associated Oil Co., 104 F.2d 537 (9th Cir. 1939), where a fraudulently unfair exchange of shares was authorized in a merger and the minority was told its only remedy was by appraisal under the California statute; PA. STAT. ANN. tit. 15, §§ 2852-810, 2852-908 (subd. C of each section reading: "The rights and remedies, at law and in equity, of any shareholder who desires to object to or to dissent from any such amendment shall be limited to those prescribed under this section, and such rights and remedies under this section shall be exclusive."); Bloch v. Baldwin Locomotive Works, 75 D. & C. 24, 38 Del. Co. 117 (1950). There seems to be no particular enthusiasm for this type of legislation elsewhere, which, to the present writer, at least, indicates that the fusion of law and morals in this area is likely to remain.

The proportion of shareholders that may vote fundamental changes, where the articles contain no governing provisions in the matter, varies considerably from state to state. While Montana permits shareholders representing "at least one-half" of the outstanding capital stock of record entitled to vote at the meeting to authorize a sale of the corporate assets,[14] other jurisdictions require not less than a majority, and most of them require at least a two-thirds vote—Alabama, in fact, requiring an affirmative vote of two-thirds of the directors and *holders* of four-fifths "in value" of the capital stock.[15] Thus, the variation is from fifty to eighty per cent, with a preponderance at 66⅔ per cent, but with a respectable number permitting a bare majority to control. The difficulty does not end with the fraction required, however, for the statutes vary considerably, too, on the question of which shareholders may vote—only those who have voting shares[16] or shares entitled to vote in case of a sale of the assets,[17] or all shareholders, whether or not they have voting rights in other cases.[18] Where there are classes of shares, the usual provision requires an affirmative proportionate vote of each class; but this provision is valueless to holders of a class of shares with no voting rights where the statute provides for a vote solely by holders of shares with voting rights or with voting rights only in case of a sale of assets.[19] And where there is no provision for a vote by classes of shares, the proportionate vote required may be carried by the common shareholders' votes, even where all shares have voting rights and a considerable portion of a class votes against the resolution. In the case of a sale of assets, this is perhaps not too troublesome a problem, although it does offer opportunities of selling out a prosperous

[14] MONT. REV. CODES ANN. § 15-901 (1955). *Cf.* CONN. GEN. STAT. § 5138 (1949) (requires authorization "by a vote of ¾ of all its outstanding stock of each class"); MO. REV. STAT. § 351.400 (1949) (requires the affirmative vote of holders of at least three-fourths of the outstanding stock entitled to vote at such meeting); S.D. CODE § 11.0709 (1939) (requires shareholders representing three-fourths of the outstanding stock to authorize a sale or mortgage); W. VA. CODE ANN. § 3076 (1955) (requires for a sale an affirmative vote of the holders of sixty per cent of the stock issued and outstanding having voting power).

[15] ALA. CODE tit. 10, § 91 (1940). Texas, likewise, requires a four-fifths vote of all outstanding shares, whether with or without voting rights. TEX. BUS. CORP. ACT art. 5.10 (1955).

[16] *E.g.*, DEL. CODE ANN. § 271 (1953) (the "affirmative vote of the holders of the majority of the stock issued and outstanding having voting power"); D.C. CODE ANN. § 29-929 (Supp. 1956) (at least two-thirds of the outstanding shares entitled to vote, and if there are two or more classes entitled to vote, each class must have a two-thirds affirmative vote); KAN. GEN. STAT. ANN. § 17-3801 (1949) (two-thirds in amount of its outstanding shares of capital stock entitled to vote); MASS. GEN. LAWS c. 156, § 42 (1932), as amended by Mass. Laws 1943, c. 38 (two-thirds of each class entitled to vote).

[17] *E.g.*, FLA. STAT. § 608.19 (1955) ("affirmative vote . . . of shareholders of record holding at least a majority of stock entitled to vote on such proposal"); GA. CODE ANN. § 22-1870 (Supp. 1955) (similar to the Florida statute); ILL. REV. STAT. c. 32, § 157.72 (1955) (approval of two-thirds of the outstanding shares entitled to vote at such meeting); N.J. REV. STAT. § 14:3-5 (1937) (two-thirds in interest of the holders of each class having voting powers on the proposal).

[18] *E.g.*, COLO. REV. STAT. ANN. § 31-6-2 (1953) (the affirmative "vote of ⅔ of the entire outstanding capital stock of the corporation"); CONN. GEN. STAT. § 5138 (1949) (provides for a sale "when authorized by a vote of ¾ of all its outstanding stock of each class").

[19] *E.g.*, D.C. CODE ANN. § 29-929 (Supp. 1956); ILL. REV. STAT. c. 32, § 157.72 (1955); MD. ANN. CODE art. 23, §§ 61, 62 (1951); MASS. GEN. LAWS c. 156, § 42 (1932), as amended by Mass. Laws 1943, c. 38.

corporation through the vote of a small proportion of the total shares outstanding, even where the sale is for shares in another company or for property other than cash.

A difference also exists in some statutes between the proportion and/or quality of shareholding interest—*i.e.,* whether with or without voting rights—necessary to authorize a sale of assets and that required in case of a merger or consolidation. For example, Alabama requires a four-fifths-in-value-of capital-stock vote to consummate a sale of assets, whereas two-thirds in value of each merging or consolidating company's shares is sufficient to accomplish a merger or consolidation.[20] On the other hand, California permits a "majority of voting power" to control in a sale of assets and not less than two-thirds of the issue, and outstanding shares, regardless of limitations or restrictions on their voting powers, to authorize a merger or consolidation.[21] And while the same proportionate vote, namely, three-fourths, is required in either case in Hawaii, only holders of shares with "voting power" have a voice in a sale of assets, although holders of shares outstanding, with or without voting rights, may be heard in the matter of a merger or consolidation.[22] May there be a difference in underlying policy justifying the different requirements in these statutes? The considerable number of statutes that draw few or no distinctions with respect to either the proportion of votes necessary or the quality of the shareholding interest in these cases, however, apparently reflects a widespread nonrecognition of such possible policy distinctions.

But there are a sufficient number of statutes prescribing different percentages of voting power—sometimes a higher percentage for a sale of assets; sometimes the reverse; sometimes prescribing that only voting shares shall vote in the case of a sale and that all shares, whether carrying a vote or not, may vote in the case of a merger or consolidation—to warrant speculation as to what might have been in the minds of the framers of these several provisions. Is it possible that shareholder rights differ relatively in the case of a sale of all or a large part of the assets of a solvent and possibly highly successful company and in the case of a merger or consolidation? Would the requirement of a larger proportionate vote or consent in one situation

[20] ALA. CODE tit. 10, §§ 91, 94 (1940). *Cf.* CONN. GEN. STAT. §§ 5138, 5222 (1949) (requires a three-fourths vote of the outstanding shares of each class for a sale of assets, but approval of two-thirds of the outstanding shares of each class for a merger or consolidation); MICH. COMP. LAWS §§ 450.57, 450.54 (Supp. 1956) (requires a majority of the outstanding shares for a sale of assets, but approval of two-thirds of the outstanding shares of each class for a merger or consolidation); MO. REV. STAT. §§ 351.400, 351.425 (1949) (requires three-fourths of the outstanding shares entitled to vote "at such meeting" for a sale of assets, but approval of two-thirds of the same shares for a merger or consolidation); N.C. GEN. STAT. §§ 55-112(c)(3), 55-108(b) (Supp. 1955) (requires a two-thirds vote of the outstanding shares for a sale of assets, but a majority vote for a merger or consolidation). Other examples could be given.

[21] CAL. CORP. CODE §§ 3901, 3902, 3903, 4107. *Cf.* MONT. REV. CODES ANN. §§ 15-901, 15-902 (1955) (allows one-half of outstanding shares of record entitled to vote at the meeting to authorize a sale of assets, but requires two-thirds of the stock to authorize a merger or consolidation).

[22] HAWAII REV. LAWS §§ 8343, 8363 (1945). *Cf.* IND. ANN. STAT. §§ 25-239, 25-231 (Supp. 1957) (vote of two-thirds of the outstanding shares entitled to vote in respect thereof for a sale of assets when corporation is meeting its matured obligations, but a majority only of the outstanding shares entitled to vote for a merger or consolidation is required for this major change). Other examples could be given.

than in the other warrant a conclusion that there are greater dangers to the shareholders inhering in the situation requiring the larger percentage vote? Should the probable dangers be sufficiently evident for rational minds to conclude that the dangers are greater in a merger or consolidation than in a sale of assets, or vice versa?

It seems doubtful that the various approaches which legislatures have adopted to these problems can be explained upon other than a flip-of-the-coin basis. And one is led to believe that there is no sound reason for requiring a different percentage or quality of shareholder interest vote in one case than is required in the other; that both situations have their special potential dangers which warrant approximately equal treatment vote-wise. There may be more ground for controversy, however, concerning the question whether each situation equally warrants giving a right to the dissenting shareholder to be paid the fair value of his shares through the appraisal procedures and how those procedures shall be exercised. These problems have yet to be considered.

First preference with respect to the right of appraisal should, perhaps, be accorded in the situation where amendments may either place ahead of an outstanding stock, whether common or preferred, another class with superior preferences, or alter all kinds of contractual rights, including the elimination of accrued but undeclared dividends on cumulative preferred shares. Yet, less than one-fifth of the states accord an appraisal right to a dissenting shareholder of a class whose shares are thus impaired.[23] If he cannot find an outside purchaser, he must keep his shares and suffer the damage attributable to the alteration. If economic conditions have justified a change of the terms of his original contract, there is, perhaps, some reason for a policy which, under such circumstances, would sanction this result. Necessity excuses many things. But the statutes do not limit such changes exclusively to those necessary to keep the corporate boat afloat. And the dangers inherent in the many substantial changes specifically permitted in a vast number of fairly recently-enacted statutes give cause for sober pause. The great bulk of these provisions, moreover, requires the board to submit amendments but gives the shareholder no right to do likewise. Hence, if the shareholder feels that dissolution or a sale of all of the assets is a better solution, he has no chance to present his case to the other shareholders.

Approximately twenty states require approval of amendments altering shareholders' rights by a two-thirds vote, with a further provision that if a class of shares is adversely affected, its holders shall have a vote as a class—usually whether they have voting rights in other situations or not—and holders of two-thirds of the shares of the class as well as holders of two-thirds of the total outstanding shares with voting rights must approve the change. Approximately the same number of states permit such changes to be approved by a majority vote, with similar action by holders of a majority of the shares of the classes affected. A few states have no

[23] See note 8 *supra*.

provision for a class vote in any case;[24] a few draw a distinction between the proportion required in the vote of a class affected[25] and that required in the vote of the other shares; and Rhode Island requires a unanimous vote in some situations, a two-thirds vote in others, and a majority vote in others.[26] Usually, where one or more classes may be affected by the change, the statutes give a vote to the shareholders of such classes, whether or not they have a voting right in other situations. But some of the statutes draw no such distinction and permit only the holders of voting shares to be heard on these important changes.[27]

There is also confusion in the *manner of statement* in some statutes as to whether the holders of voting shares are intended to be the only ones that may be heard, or whether all shareholders may vote, or whether, in special circumstances, some shareholders not otherwise entitled to vote may do so in the case at hand. But, by and large, the statutes are clear as to who may vote and when. And this is important, for there is enough confusion in the area of fundamental change without more being caused by careless draftsmanship.

Where voluntary dissolution is the fundamental change anticipated, thirty-four states and the District of Columbia require a two-thirds vote, several require not less than a majority vote, one omits any statement on the proportionate vote required, and the remaining six require from a fifty to eighty per cent vote.[28] Again, there is no agreement as to which shareholders may vote—whether those with voting rights, those with such rights on a resolution for dissolution, or all, whether with or without voting rights in other matters. A few statutes, but only a few, recognize specifically the case of deadlocked boards and/or shareholders, a situation which in the closely-held corporation can be embarrassing and damaging in a vital sense. It would seem that all corporation statutes should contain some provision for dissolution in such cases, either summarily upon application of a shareholder or upon proof that dissolution is for the best interests of the corporation and its shareholders when they cannot break the deadlock by other means.[29] There are also a

[24] *E.g.*, MONT. REV. CODES ANN. § 15-203 (1947) (two-thirds of the shares entitled to vote at such a meeting, but no class vote unless the articles provide for this); S.D. CODE § 11.0206 (Supp. 1952).

[25] MAINE REV. STAT. ANN. c. 53, § 75 (1954) (requires a majority of the shares entitled to vote, but also a class vote, when the class is affected as described in statute, of eighty per cent of the shares of the class); KY. REV. STAT. § 271.445 (1953) (requires a majority of the shares entitled to vote, with the addition of a two-thirds vote of the class adversely affected); MO. REV. STAT. § 351.090 (1949) (a complicated statute, but a majority of the shares entitled to vote, plus seventy-five per cent of the shares of the class adversely affected, and in some cases, a unanimous vote of the shares of a class is required).

[26] R.I. GEN. LAWS ANN. c. 116, § 50 (1938).

[27] N.H. REV. STAT. ANN. §§ 294.40, 294.41, as amended by N.H. Laws 1955, c. 19; N.M. STAT. ANN. § 51-2-20 (1953); N.Y. STOCK CORP. LAW § 37.

[28] Florida, Kentucky, Massachusetts, New Hampshire, Oregon, Pennsylvania, and South Carolina provide for a majority or, in some cases, "not less than majority" vote. California permits a fifty per cent vote, and Rhode Island prescribes fifty per cent "or more." West Virginia requires a sixty per cent, Connecticut a three-fourths, and Alabama and Texas a four-fifths vote. No proportion is stated in the Vermont statute. All have to be watched to see whether the vote is limited to voting shares or to shares entitled to vote on a liquidation resolution.

[29] See N.Y. GEN. CORP. LAW § 103; CAL. CORP. CODE § 4650 (one half of directors or holders of one third of outstanding shares are allowed to petition for dissolution); N.C. GEN. STAT. § 55-125 (1) and (2) (Supp. 1955). There are other excellent provisions in this well-framed North Carolina section.

number of situations where dissolution should be left to the board of directors, thus saving time and expense in dissolving a corporation in special situations, such as insolvency, bankruptcy, end of term of life, etc.; and a fair number of statutes today make such exceptions from those requiring a shareholder's vote.[30] And, as is usual in other fundamental-change situations, there is, as a rule, a provision for dissolution upon the written consent of all the shareholders.

Recent appraisal provisions have generally been prolix in statement, spelling out to the last detail the procedures that must be followed by dissenters to secure payment for their shares. Little attempt, apparently, has been made to simplify these statutory provisions so that the layman might have some conception of their full import. Some things should be stated, and these include the events giving rise to appraisal rights; a description of the shares or classes entitled to appraisal; the kind of dissent to, or objection to, or vote against the proposed change that must precede assertion of the right of appraisal; the machinery to be employed in making the appraisal when the shareholder and his corporation do not agree on value; and the point at which some value becomes final, with no further contest possible by the corporation or the dissenting shareholder. There should also be clear indication of when the dissenter loses his status as a shareholder, so that cash and share dividends or pre-emptive and other rights to which he might otherwise have become entitled thereafter may not accrue to him or to his assignee or devisee; or whether he retains all or a part of his rights as a shareholder from the time of his dissent and demand until the actual payment or tender of payment and surrender of his shares.[31] If the dissenter loses his shareholder status when he demands that he be paid the fair value of his shares, provision should be made for the highest legal rate of interest from that date to the date of actual payment; and if the anticipated transaction does not materialize, but is abandoned, his rights as a shareholder should be secured in such manner that, except for the voting right in the interim, he will receive everything that other shareholders in the majority group did. It should be clear, too, whether his corporation is to pay him in the case of a merger or consolidation or a sale of assets for shares in the buying corporation, or whether he is to be paid by the surviving corporation in the merger, the new corporation arising from the consolidation, or the corporation purchasing the assets, as the case may be. It should be just as clear whether the payment may be made out of any funds or only those usually legally applicable when shares are purchased by the corporation under other circumstances. There should be, as well, a point at which the corporation must elect whether it will abandon the project or consummate it and undertake the paying off of the dissenters. And to complete the remedy, there should be provision for the payment of the costs of appraisal.

There is still merit in the brevity of the statement of the provisions contained in the Model Business Corporation Act of 1928,[32] originally denominated the Uni-

[30] See, for good recent statutory example, N.C. GEN. STAT. § 55-116 (Supp. 1955).

[31] See Fein v. Lanston Monotype Machine Co., 196 Va. 753, 85 S.E.2d 353 (1955).

[32] 9 U.L.A. 115 (1957).

form Business Corporation Act. In three rather short paragraphs, section forty-two of this Act was able to state simply, without embellishment or tautology, the essentials of dissent, demand, effect of failure to agree, appraisal, and finality of appraisal, with a protective provision preventing payment if the debts and liabilities, not including that of capital stock, exceed the value of the corporate assets. Section forty-eight added in one short paragraph the right of appraisal in the case of a merger or consolidation, making the liability to pay for the dissenters' shares "also a liability of the surviving or new corporation, as the case may be." These provisions were drafted at a time when little was known of the finer points that needed solution, but legislators might well study them as fine examples of the simplicity and clarity of statement which all legislation should possess.

The Michigan statute, which became effective in 1931 and which was one of the early statutes with fairly adequate provisions concerning dissenting shareholders,[33] was fashioned after the 1928 Model Act and the Ohio Act of 1927.[34] Not as brief, but still short when compared with several of the more recent statutes, it exhibits, in large part, the clarity necessary to make it workable, although one may not agree entirely with some of its features. For example, why should it be necessary for a shareholder to vote *against* a proposal as a condition of his right to seek appraisal? If a shareholder has not voted *for* a proposal, why should he not be allowed to demand an appraisal within the specified period of time? Again, why should a shareholder's right to contest the fairness—or even the downright fraud—of a sale, lease, or exchange of corporate property, or the terms of a merger or consolidation, or any other transaction where appraisal rights are given be cut off by making appraisal "his exclusive remedy?"[35]

When the corporation and the shareholder cannot agree, the 1928 Model Act makes final the appraisers' finding of the "value of the shares at the time such corporate action was authorized," which amount, if not paid within thirty days, may be recovered by the shareholder in an action against the corporation.[36] The Michigan statute is not quite as summary, for it requires the court, rather than the parties, to select the appraisers and further requires court confirmation of the appraisers' report before it becomes "final and conclusive," no appeal being permitted.[37] The Michigan statute also provides for the exclusion of any appreciation or depreciation in the "fair cash value" of the shares owing to the corporate action as of the day prior to the day

[33] MICH. COMP. LAWS §§ 450.44 (1948), 450.54 (Supp. 1956).

[34] 112 Ohio Laws §§ 8623-1-138 (1927).

[35] Note 33 *supra*. The California statute also makes appraisal a dissenter's sole remedy. CAL. CORP. CODE § 4123. See also Porter v. C. O. Porter Machinery Co., 336 Mich. 437, 456, 58 N.W.2d 135, 137 (1953); Beechwood Securities Corp. Inc. v. Associated Oil Co., 104 F.2d 537 (9th Cir. 1939) (interpreting the California statute where fraud was claimed). But while the Michigan statute purports to make the appraisal remedy exclusive, see HORACE L. WILGUS AND BURRITT HAMILTON, MICHIGAN CORPORATION LAW 323 (1932) and the dictum in the *Porter* case, *supra* at 456, 58 N.W.2d at 137. *Cf.* Pennsylvania statute, *supra* note 13; Beloff v. Consolidated Edison Co. of N.Y., 300 N.Y. 11, 87 N.E.2d 561 (1949).

[36] MODEL BUSINESS CORPORATION ACT OF 1928 § 42.

[37] Note 33 *supra*.

"such action was authorized by the shareholders,"[38] a common provision in modern statutes, whereas the 1928 Model Act contains no reference to this matter. The Michigan statute further requires the shareholder to surrender his share certificates to the corporation when he makes his demand for payment, in contrast with those few present-day statutes that require him to present his shares to have stamped upon them the fact that they are dissenting shares.[39]

Concerning the culmination of the appraisal procedure, the Michigan statute provides that the final act of payment for dissenting holders' shares shall only be made when the value of the corporate assets after payment would exceed 110 per cent of the aggregate amount of the corporation's debts and liabilities, excluding capital stock, "and if such excess shall be at least equal to the awarded and/or agreed fair cash value of the shares of shareholders demanding payment."[40] Does not this quoted clause mean that if the corporation has assets equal to 110 per cent of its liabilities, etc., and $1,000,000 more, then if the appraisal value of the dissenting holders' shares amounts to $1,000,100, nothing can be paid to them and the corporation may go ahead with its sale, lease or exchange, without reference to their appraisal rights? This provision, however, apparently has no application in the case of a merger or consolidation, where payment must be made by the "resulting" corporation.[41]

The Michigan statute also contains provisions disentitling the dissenting holder who demands payment to the rights arising from his ownership of shares, unless the corporation abandons its plans or he withdraws his demand with the board's consent. Interest is mentioned in neither this statute nor in the 1928 Model Act, although it should be pertinent in any case where the shareholder's rights are suspended or payment is to be made on a valuation determined as of a date prior to or as of the date of the corporate action giving the appraisal right. The corporation has the use of the money during the ensuing interim period, and corporate earnings during that period are not to be considered in fixing the value. If cash or stock dividends are declared or pre-emptive rights acquired during the period, however, and the statute does not mention these or the suspension of shareholder rights after demand for payment, it seems clear that the shareholder would be entitled to these benefits.

Having examined a model act of early vintage and a state statute of the same period which has sustained but minor change since becoming effective, it should be interesting to compare the very recent American Bar Association's Model Business Corporation Act in its revised edition of 1953 with one of the most modern of the

[38] *Ibid.*

[39] *Ibid.* But *cf.* OHIO REV. CODE ANN. § 1701.85(A) (Page Supp. 1956) (if the corporation requests it, the certificates must be submitted for the purpose of indorsing thereon "a legend to the effect that demand for the fair cash value of such shares has been made"); CAL. CORP. CODE § 4302 (shares must be stamped that they are dissenting shares, with a provision that upon subsequent transfer on the books, the new certificates shall bear a like statement, together with the name of the original dissenting holder of the shares).

[40] Note 33 *supra*.

[41] *Ibid.*

recent state corporation statutes, that of North Carolina. The 1953 Model Act was prepared by a committee of the American Bar Association over a period of years, an initial draft having been published in 1946, following a preliminary report published in 1943. Simplicity and clarity of expression as well as style were sought by the draftsmen, and, having satisfied, in a large measure, its draftsmen's objectives, the 1953 Model Act should be instructive as an example of what can be done with the English language if men devoted to a search for "plain and precise" language set out to do a job. Furthermore, "a great deal of consideration has been given to the rights of shareholders," the draftsmen admitting that such rights have almost ceased to exist in some states.[42]

There are two sections in the 1953 Model Act which accord appraisal rights to dissenting shareholders: (1) section seventy-one, which pertains to mergers and consolidations; and (2) section seventy-four, which applies in the case of a sale or exchange of all or substantially all of the assets of a corporation in other than the usual and regular course of business. Unfortunately, however, no appraisal rights are granted in the case of amendments which seriously impair the share-contract rights, a situation in which shareholders most certainly deserve protection. Although a host of major changes may be made in his contract rights, the only protection the shareholder can assert is the right to a class vote, whether or not his shares have that right on other occasions, and the requirement that there be at least a two-thirds vote of his class and a similar proportion of other classses affected and of the remaining shares in favor of the change.

The new North Carolina statute, which became effective July 1, 1957, goes much farther, however, in the matter of protecting dissenting shareholders.[43] Voting rights are given in all cases where appraisal is permitted, as in the 1953 Model Act, with class-voting rights being preserved where amendments adversely affect the share-contract, and appraisal rights being granted to objecting shares with preferences as to dividends or liquidation in specifically stated situations where their holders' interests will be prejudiced.[44] There is also a much-needed provision to protect dissenting holders against a recapitalization which creates a new class of shares, or other securities, with priorities in rights over existing preferred shares upon which there are accrued dividends or dividend credits, even though the preferred shareholder is offered the opportunity of turning in his own shares for the new ones.[45] This provision, no doubt, is intended to obviate the effect of some drastic decisions which permitted accrued but undeclared dividends effectively to be wiped out by this

[42] See Mr. Ray Garrett's preface to the 1950 revision. COMMITTEE ON CORPORATE LAWS, AMERICAN BAR ASSOCIATION, MODEL BUSINESS CORPORATION ACT iv-x (1953). The history and purposes of the Act are here set out. Some slight revisions, together with accompanying optional provisions, appear in a nine-page pamphlet, published in 1955. *Id.*, REVISIONS AND OPTIONAL SECTIONS (1955).

[43] N.C. GEN. STAT. § 55-113 (Supp. 1955). Fundamental changes start with § 55-99 and are stated in terse, short subsections wherever possible, thus making for clarity and easy understanding.

[44] *Id.* § 55-101.

[45] *Id.* §§ 55-101(b)(2), 55-102. These two provisions are directed at the same evil, but § 55-102 is concerned with a situation not requiring an amendment to the articles.

method, where it was impossible under the then existing law to destroy such rights by a "direct" amendment.[46] And, of course, under the majority decisions which permitted this rough treatment, no appraisal right existed without the aid of a statute. Moreover, upon dissolution, where liquidation is effected by a transfer of assets in kind "to the shareholders collectively as co-owners," the North Carolina statute also gives an appraisal right.[47] Merger and consolidation, too, with domestic or foreign corporations gives a dissenting shareholder the right to be paid the fair value of his shares, "in addition to any other right he may have in law or equity," thus specifically assuring him that appraisal is not his only remedy.[48] He can, thus, enjoin an unfair or fraudulent merger or consolidation, a remedy which neither the California nor the Michigan statutes seems to countenance.[49] And this statute affords appraisal remedies as well to one who dissents and demands payment in the statutorily-prescribed manner upon a sale of assets for shares of another corporation.[50]

A salient feature of the North Carolina statute which should encourage honest action by the majority junior shareholders when major changes are contemplated is a provision which dictates that "the fair value of any shares entitled to preference on liquidation shall in no event be found to be less than two-thirds of the amount of the preference to which said shares would have been entitled on a voluntary liquidation on the date herein" if junior shares retain a participation in the corporation without payment therefor, and in case of payment for participation, if the value of the participation exceeds the payment for it.[51] There will, no doubt, be practical difficulties in ascertaining the value of a particular participation, but the problem is no more difficult than that which confronts appraisers in determining the "value," "fair value," "fair market value," or "fair cash value" of dissenting shares, for very few statutes give any indication of tests of value to be employed in making appraisals.

[46] See, *e.g.*, Barrett v. Denver Tramway Corp., 53 F. Supp. 198 (D.Del. 1943), *aff'd*, 146 F.2d 701 (3d Cir. 1944); Johnson v. Lamprecht, 133 Ohio St. 567, 15 N.E.2d 127 (1938); Shanik v. White Sewing Machine Corp., 25 Del. Ch. 371, 19 A.2d 831 (Sup. Ct. 1941). *Contra*, Patterson v. Durham Hosiery Mills, 214 N.C. 806, 200 S.E. 906 (1939). For other cases, see HENRY W. BALLANTINE, NORMAN D. LATTIN, AND RICHARD W. JENNINGS, CASES AND MATERIALS ON CORPORATIONS 988 n. 2 (2d ed. 1953).

[47] N.C. GEN. STAT. § 55-119(b) (Supp. 1955).

[48] "In addition to any other right he may have in law or equity, a shareholder giving such notice shall be entitled, if and when the amendment, dissolution, merger, consolidation or sale of assets for shares is effected, to be paid by the corporation the fair value of his shares, as of the day prior to the date on which the vote was taken, subject only to the surrender by him of the certificate representing his shares." *Id.* § 55-113 (b). This section gives dissenters in North Carolina corporations the same rights whether the merger or consolidation be wholly between domestic corporations, *id.* § 55-108, or between domestic and foreign corporations, *id.* § 55-111, and regardless of the domiciliary state of the merging corporation. See *id.* § 55-111(e)(1) and (2).

[49] See notes 33 and 35 *supra*, particularly the Michigan case, which suggests that a fraudulent deal might demand different treatment.

[50] N.C. GEN. STAT. §§ 55-112(c)(2), 113(b), 113(1) (Supp. 1955), the last section defining the meaning of "sale of assets for shares."

[51] *Id.* § 55-113(e).

Another fine feature of the North Carolina statute is the requirement that in appropriate situations, the corporation's notice to its shareholders contain a statement that dissenting shareholders are entitled to appraisal rights upon compliance with section 55-113, together with a specific statement of the twenty-day-notice period during which demand for payment for the fair value of the objecting shares may be made.[52] Many shareholders are unaware of such rights, and this notice should give them the opportunity to investigate and make a timely demand for payment if they wish it. The provision found in many statutes requiring the dissenting holder who desires payment for his shares to state what he considers to be their value[53] is believed to be of little practical use, and the fact that the North Carolina statute omits this indicates legislative concurrence in the futility of such provisions, based on the experience of other states which have enacted them. There is more sense to a provision requiring the corporation to state what it considers to be the fair value of its dissenting shares and, if appraisal becomes necessary, owing to disagreement concerning their value, to require the corporation to pay all costs of appraisal, plus reasonable attorney's fees of the dissenter, if the appraisers' valuation is higher than that of the corporation and there is judicial affirmation of this valuation. The corporation, after all, has the means of ascertaining the value of its shares, whereas the shareholder is hard put to find out more than the market value, if indeed, there is one.

The appraisal machinery provided by the North Carolina statute is fairly similar to that found in many other statutes. The appraisal value date is "the day prior to the date on which the vote was taken," and there is no provision for considering appreciation or depreciation resulting from the proposal acted upon which gave rise to the appraisal right.[54] Since there is little chance of determining the amount of appreciation or depreciation attributable to the particular corporate action, the omission is a wise one. Furthermore, if the philosophy behind the payment for dissenters' shares is that the dissenters have some right to continue as owners, they should be given an owners' redress, rather than that which they would have received had there been a dissolution, with a paying of creditors and a division of the remaining assets among shareholders. Of course, under this theory, they take their chances that a depreciation as well as an appreciation may result from the corporate fundamental change.

Appraisal provisions in the North Carolina statute which deserve special praise are (1) the right of all shareholders having appraisal rights to vote, together with

[52] *Id.* §§ 55-102(b) (offer of exchange of securities for preferred shares), 55-100(b)(2) (for amendments generally), 55-108(a) (for mergers and consolidations), 55-112(c)(2) (for sales, leases, and exchanges).

[53] See, *e.g.*, OHIO REV. CODE ANN. § 1701.85(A) (Page Supp. 1956).

[54] N.C. GEN. STAT. § 55-113(b), (c) (Supp. 1955) (subsection (c) concerns a special case). Provisions which are similarly aimed at eliminating appreciation and depreciation so caused are common. *But see* OHIO REV. CODE ANN. § 1701.85 (C) (Page Supp. 1956), which contains an unusual definition of "fair cash value." This provision was inserted in the Ohio statute because the committee framing it was dissatisfied with the court's interpretation of "fair cash value" as "intrinsic value" in Roessler v. Security Savings & Loan Co., 147 Ohio St. 480, 72 N.E.2d 259 (1947).

their right to have notice of what their appraisal rights are and notice of the time within which they must exercise these rights; (2) the specific retention by the shareholders of all other legal and equitable remedies, thus assuring a means to attack unfair or fraudulent action, and not solely a right to appraisal; (3) a fair coverage of the several situations which, as a matter of policy, require appraisal remedies, especially share-contract changes of a basic sort, whether by charter amendments compulsory in effect or by "voluntary" exchanges by other shareholders for new securities with priorities over the old shares; and (4) a simplicity of statement and of paragraphing and subparagraphing which makes the statute an easy one to follow and to understand.

CONCLUSION

The recent statutory appraisal provisions show much improvement over those of approximately a quarter of a century ago.[55] In most of the recent statutes, specific provision is made for such problems as when a shareholder's rights as shareholder cease, whether interest is to be paid on the shares appraised and during what interval, what shareholders may vote and whether by classes or not, and other important matters. There is still a need for a simpler and shorter statement in appraisal statutes, and one wonders, after appraisers have presented their figures to a trial court and that court has confirmed their determination or made a different one, whether an appeal to a higher court is justified. If there is justification, it is only by virtue of the fact that there is little agreement as to what elements must be considered in arriving at a conclusion of what constitutes fair value—or whatever the statute requires. And there is about as much confusion today over this important question as there was a quarter of a century ago.[56] If appraisal experts can find one or several tests that should be used in such cases, it might be well to suggest that they be placed as guides in the statutes, especially where a more or less summary method of determining value is provided.

[55] The writer had occasion to review such statutes at that time in an article, Lattin, *Remedies of Dissenting Stockholders Under Appraisal Statutes*, 45 HARV. L. REV. 233 (1931), and was critical of the statutes which made appraisal a sole remedy in a later article, Lattin, *A Reappraisal of Appraisal Statutes*, 38 MICH. L. REV. 1165 (1940).

[56] On the valuation problems, see Application of Behrens, 61 N.Y.S.2d 179 (Sup. Ct. 1946), *aff'd*, 271 App. Div. 1007, 69 N.Y.S.2d 910 (1st Dep't 1947); *In re* General Realty & Utilities Corp., 29 Del. Ch. 480, 52 A.2d 6 (Ch. 1947); Chicago Corp. v. Munds, 20 Del. Ch. 142, 172 Atl. 452 (Ch. 1934); Roessler v. Security Savings & Loan Co., 147 Ohio St. 480, 72 N.E.2d 259 (1947), the effect of which has been cured by OHIO REV. CODE ANN. § 1701.85(C) (Page Supp. 1956). See *supra* note 54. The very recent case of Phelps v. Watson-Stillman Co., 293 S.W.2d 429 (Mo. 1956) discusses the leading cases on valuation; and see also the materials in BALLANTINE, LATTIN, AND JENNINGS, *op. cit. supra* note 46, at 1029 n. 1.

INDEMNIFICATION OF INSIDERS' LITIGATION EXPENSES

George T. Frampton*

Litigation expenses are borne cheerlessly at best. All the less bearable are they when charged to the "wrong" party. If such a mischarge could be prevented by a simple formula whenever corporate insiders[1] are involved in litigation arising from management of the business, the common law well might have found that formula; and statutory modifications, where necessary at all, could have been brief, uniform, and satisfactory.

But determining whether a particular litigation expense is a legitimate cost of the business or a personal risk of the insider-defendant requires consideration of a variety of possible circumstances. Neither the common law nor most of the twenty-four statutory enactments of the last sixteen years have given due recognition to the relevance of these circumstances, nor have they agreed on whether the courts or the directors themselves should make the determination.

These circumstances and their interrelated bearing on the propriety of indemnity are suggested by four general questions:

First, what was the nature of the litigation? It may have been an action in which the corporation was the plaintiff, either on its own initiative or in an action brought derivatively by its shareholders or creditors. It may have been brought by private parties, hostile to the corporation, against the corporation and the insiders to enforce a private right or a public policy. It may have been initiated by shareholders in the course of a proxy contest to test the validity of corporate practices or procedures allegedly giving an unfair advantage to insiders in the contest.[2] Or it may have been a government proceeding, civil or criminal, against the corporation and its insiders to exact a fine or otherwise penalize or enjoin corporate conduct or practices initiated or approved by the insiders.

Second, what was the nature of the act or conduct complained of? It may have

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[1] Most statutes now define "insiders" to include former, present, and future directors and officers of the corporation and also persons who may have been requested by the corporation to serve as directors or officers of another corporation in which the corporation has an interest.

[2] Litigation of this type has arisen out of all the following recent proxy contests in widely-held corporations: American Woolen (Textron, Inc. v. American Woolen Co., 122 F. Supp. 305 (E.D. Mass. 1954)); New York Central (Schildkret v. Ebbott, 148 N.Y.S.2d 678 (Sup. Ct.), *aff'd*, 1 App. Div. 2d 879, 150 N.Y.S.2d 773 (1st Dep't 1956) (action by Young and Kirby against insiders before the election of directors was consolidated with other actions brought after the election)); Montgomery Ward (Wolfson v. Avery, 6 Ill.2d 78, 126 N.E.2d 701 (1955)); Fairbanks-Morse (Penn-Texas Corp. v. Morse, 242 F.2d 243 (7th Cir. 1957)); Loew's (Tomlinson v. Loew's, Inc., 134 A.2d 518, *aff'd*, 135 A.2d 136 (Del. Ch. 1957)); Campbell v. Loew's, Inc., 134 A.2d 852 (Del. Ch. 1957)).

been such that the defendant knew or ought to have known that it was wrong. Or it may have been such that he could not fairly be charged with foreseeing the possibility that it would be alleged or found to be unlawful.

Third, what was the disposition of the action? The insiders may have been wholly vindicated by judgment or dismissal on the merits. The action may have been terminated by the litigative process unfavorably for either party otherwise than on the merits. Or part of what the plaintiff sought may have been granted, the rest refused. Most likely, considering the small proportion of actions that ever proceed to final judgment, it was settled. The settlement may have obviated any judicial pronouncement on the merits. Or it may have been effected, after a verdict or judgment for or against the insiders, to avoid an appeal.

Finally, what was the relationship between "ownership" and insider-management in this corporation, and, in the light of that relationship, what internal action was taken or procedure followed regarding both the act or conduct complained of and the act of indemnification itself? As to the act complained of, the shareholders may have approved it. As to indemnification, they may have voted specifically that the corporation assume the expense of defending the act complained of. In either case, the disinterestedness of the assenting shareholders is relevant. And if they have not voted, the question remains whether there are interests to be protected against the particular indemnity and whether the corporate procedures usually prescribed for the protection of those interests when analogous corporate decisions are made have been followed in the decision to indemnify.

By 1941, scarcely more than twenty major cases and no statutes dealt with indemnification of directors for litigation expenses. With few exceptions,[3] the cases arose out of shareholders' derivative actions in which wrongdoing by insiders was alleged and a money recovery for the corporation was the principal relief sought.

These pre-statute cases, in their inattention to the relevance of the circumstances suggested above or in their failure, when they did refer to the circumstances, to state meaningful criteria for weighing them, set the stage for statutory action. Although the corporation realized recoveries in many of the derivative actions, so that the courts were able to come rather easily to the conclusion that indemnification for litigation fees should not be allowed to the unsuccessful defendants,[4] the courts

[3] Jesse v. Four Wheel Drive Auto Co., 177 Wis. 627, 189 N.W. 276 (1922); Albrecht, Maguire & Co., Inc. v. General Plastics, Inc., 256 App. Div. 134, 9 N.Y.S.2d 415 (4th Dep't 1939). In Mason v. Pewabic Min. Co., 66 Fed. 391 (6th Cir. 1894), plaintiffs asked not for a money accounting, but for dissolution of the corporation and distribution of its assets in lieu of a plan of defendants for sale of assets and continuation of the business. See also note 14 *infra*.

[4] Mason v. Pewabic Min. Co., *supra* note 3; Wickersham v. Crittenden, 106 Cal. 329, 39 Pac. 603 (1895); McConnell v. Combination Mining & Milling Co., 31 Mont. 563, 572, 79 Pac. 248, 251 (1905); McCourt v. Singers-Bigger, 145 Fed. 103 (8th Cir. 1906); Chabot & Richard Co. v. Chabot, 109 Me. 403, 84 Atl. 892 (1912); Hooker, Corser and Mitchell Co. v. Hooker, 88 Vt. 335, 92 Atl. 443 (1914); Brock v. Automobile Livery & Sales Co., 137 La. 9, 68 So. 195 (1915); General Mortgage and Loan Corp. v. Guaranty Mortgage and Securities Corp., 264 Mass. 253, 162 N.E. 319 (1928); Apfel v. Auditore, 223 App. Div. 457, 228 N.Y. Supp. 489 (1st Dep't 1928); Monahan v. Kenny, 248 App. Div. 159, 288 N.Y. Supp. 323 (1st Dep't 1936); Atwater v. Elkhorn Valley Coal-Land Co., 184 App. Div. 253, 258-59, 171 N.Y. Supp. 552, 556 (1st Dep't 1918) (dictum), *aff'd*, 227 N.Y. 611, 125 N.E. 912 (1919).

did not say that indemnity would be denied only when defendants had been unsuccessful. Neither did they say that success by defendants in derivative actions would bring indemnity; nor, where they granted indemnity to defendants who had been wholly or partly successful,[5] that it was based on success. They instead talked about whether counsel had actually represented the individual defendants or the corporation. This led them to inquire whether the corporate defendant had "interests" to be protected that would require representation or whether it had any "benefit" to receive from representation; and they concluded when plaintiffs won substantial victories that the corporation was neither represented nor benefited by defendants' counsel.[6] This test, of course, ignores the question whether the defense of the individual, even when the corporation is not "directly" represented, cannot in some cases be a proper cost of the business. This test would also lead to the conclusion that indemnity is as inappropriate when the insider in a derivative action is wholly successful in his defense as when he is unsuccessful.

This test, moreover, led to a misconception so persistent in the cases that it has misshaped some of the statutes. The courts said that in the absence of a "benefit" to the corporation *in the defense,* there was an absence of "power" in the corporation to indemnify. This "power" argument was used, inappropriately, in cases where insiders sought indemnity against a corporation unwilling to grant it.[7] The "power" of the corporation, therefore, was not at issue in those cases. While an absence of benefit in the defense itself may be a logical reason for refusing to find a right to indemnity against an unwilling corporation, the power of a willing corporation to make indemnity could be based on benefits to the corporation quite beyond the value to it of the immediate defense. The growing need of corporations to improve their relationships with their employees, management and otherwise,

[5] Esposito v. Riverside Sand & Gravel Co., 287 Mass. 185, 191 N.E. 363 (1934); Solimine v. Hollander, 129 N.J. Eq. 264, 19 A.2d 344 (Ch. 1941).

[6] Wickersham v. Crittenden, 106 Cal. 329, 330, 39 Pac. 603, 603 (1895); Chabot & Richard Co. v. Chabot, 109 Me. 403, 407, 84 Atl. 892, 894 (1912); Brock v. Automobile Livery & Sales Co., 137 La. 9, 12, 68 So. 195, 196 (1915); General Mortgage and Loan Corp. v. Guaranty Mortgage and Securities Corp., 264 Mass. 253, 261, 264, 162 N.E. 319, 322, 323 (1918) (but finding that attorney's services did not "benefit" corporation held not to require attorney to return fees paid by corporation, because there was no finding that he "knew" his services would not benefit corporation); Apfel v. Auditore, 223 App. Div. 457, 458, 228 N.Y. Supp. 489, 490 (1st Dept. 1928); Monahan v. Kenny, 248 App. Div. 159, 160-61, 288 N.Y. Supp. 323, 324 (1st Dept. 1936); Wood v. Noma Electric Corp., 96 N.Y.L.J. 1121 (City Ct. 1936).

[7] Chabot & Richard Co. v. Chabot, *supra* note 6; Jesse v. Four Wheel Drive Auto Co., 177 Wis. 627, 634, 189 N.W. 276, 278 (1922); Griesse v. Lang, 37 Ohio App. 553, 556, 175 N.E. 222, 223 (1931) (quoting with approval the passage from the *Jesse* case, *supra*); New York Dock Co. v. McCollum, 173 Misc. 106, 16 N.Y.S.2d 844 (Sup. Ct. 1939). The New York Dock Company was in an anomalous position on this point. The defendant directors had been successful and presumably wanted to vote indemnity but were "reluctant" to do so only because they did not know whether they could "safely" do so under the law (*i.e.,* whether the corporation had the "power" to do so, even though willing). By agreement, a declaratory judgment was sought, and the corporation was represented by independent counsel who construed their obligation as requiring them to argue, as though representing an unwilling corporation, that if there were no automatic legal obligation to pay, a decision to pay would be beyond the corporation's powers. See Washington, *Litigation Expenses of Corporate Directors in Stockholders' Suits,* 40 COLUM. L. REV. 431, 442-43 (1940).

and the emerging social role assumed by or imposed upon them by their size and influence have opened new areas in which the "power" of a corporation to act for corporate interests that are indirect and intangible is now recognized. Such interests support payments and commitments in discharge of moral obligations; for community, charitable, and educational purposes; and, more strikingly analogous to "underwriting" an employee's service-connected litigation expenses, for compensation and fringe benefits of a wide variety, including workmen's compensation insurance and payments, disability payments, pensions, stock-option plans, and sickness, medical, and rehabilitation plans and funds.[8] Such interests, to be sure, might have occurred more readily to the courts had any case presented squarely the validity of an indemnity agreed to by the corporation before the litigation arose. But such a benefit, once recognized, could conceivably support an undertaking under proper circumstances after the litigation arose.

The courts, however, gave no sign of having considered that a "power" to indemnify, where the corporation was willing to undertake such an obligation, could be supported in any case by a benefit to the corporation in the form of protection of the insider against business-connected litigation costs. Thus unanalyzed, the "lack of power" doctrine barred the path to a sensible inquiry whether a particular expense was one which the corporation could at least elect to assume as a legitimate cost of doing business. And it hampered the common law in reaching a case-by-case but consistent philosophy about how the relevant circumstances in an indemnity case should be weighed.

This failure to provide workable rules in the easily-decided cases where defendants were unsuccessful in derivative actions left the courts at sea in the later cases where defendants were wholly or partly successful. In *Figge v. Bergenthal,*[9] the earliest indemnity case arising out of a derivative action in which defendants won a partial victory on the merits, other claims having been held barred by limitations, the court allowed indemnity, but made no reference in its opinion to the weight it accorded the action of the defendant majority shareholders in voting indemnity during the trial. Thereafter, in the derivative action of *Griesse v. Lang,*[10] in which defendants were wholly successful, indemnity was disallowed, and *Figge* was distinguished on the grounds that no action was taken by the *Lang* shareholders.[11] But then, in *Esposito v. Riverside Sand & Gravel Co.,*[12] defendants were partially successful and partially unsuccessful, and indemnity was allowed, without any reference to possible corporate action by shareholders or otherwise. To further the uncertainty, the almost wholly unsuccessful defendants in *Godley v. Crandall & Godley Co.,*[13] were

[8] See Jervis, *Corporate Agreements to Pay Directors' Expenses in Stockholders' Suits,* 40 COLUM. L. REV. 1192, 1199-200 (1940); Bishop, *Current Status of Corporate Directors' Rights to Indemnification,* 69 HARV. L. REV. 1057, 1062 (1956).

[9] 130 Wis. 594, 109 N.W. 581 (1907).

[10] 37 Ohio App. 553, 175 N.E. 222 (1931).

[11] 37 Ohio App. at 556, 175 N.E. at 223.

[12] 287 Mass. 185, 191 N.E. 363 (1934).

[13] 153 App. Div. 697, 139 N.Y. Supp. 236 (1st Dep't 1912), *modified,* 212 N.Y. 121, 105 N.E. 818 (1914); 181 App. Div. 75, 168 N.Y. Supp. 251 (1st Dep't 1917), *aff'd,* 227 N.Y. 656, 126 N.E. 908 (1920).

allowed indemnity on the grounds that a receivership of the corporation as well as an accounting against the individuals had been sought and had been successfully resisted in part.[14]

Neither did clear rules emerge from the opinions in the cases arising out of nonderivative actions. In *Jesse v. Four Wheel Drive Auto Co.*,[15] indemnity was refused with regard to a personal action for fraud against insiders in the purchase of stock, without regard to the disposition of the action, which was pending at the time of the decision on litigation expenses, and also in disregard of a shareholders' resolution, adopted without objection, authorizing the defraying of expenses of the defense. In *Albrecht Maguire & Co. v. General Plastics, Inc.*,[16] on the other hand, indemnity was allowed, even though plaintiffs were successful in their contention that nonassenting shareholders could not be deprived of their pre-emptive rights by an amendment to the certificate of incorporation. No action by directors or shareholders on the indemnity matter was indicated, nor was anything said about the composition of the shareholdings in relation to the purpose or effect of the issuance complained of. Indemnity was allowed, the court indicated, because the insiders "acted in good faith" and issued stock pursuant to a vote of the shareholders.[17] While the results in both cases may have been justifiable, they were reached without the support of articulated rules.

[14] The *Godley* case, however, does not clearly support the proposition, for which it is frequently cited, that indemnity will be allowed whenever the complaint seeks a receivership as well as relief against the individuals. The Appellate Division and Court of Appeals described the complaint in the *Elizabeth Godley* action (1912) as alleging only wrongful payments to the directors, who were adjudged liable by the trial court, the Appellate Division, and the Court of Appeals, and who were directed to repay to the corporation more than $100,000. The trial court also ordered defendants to repay amounts disbursed by the corporation for their litigation expenses in the action. The Appellate Division agreed that "it would seem as if the directors who were responsible for the conditions that required the action should pay such [litigation] expenses, instead of the corporation itself." 153 App. Div. at 714, 139 N.Y. Supp. at 249. The Court of Appeals modified the judgment on this point, however, because the original complaint had not sought any return of payments made for litigation expenses during the action and because there remained some uncertainty in the evidence as to the precise amount paid for such expenses by the corporation; but it did so "without prejudice . . . to the plaintiff's right to bring a new action therefor if so advised." 212 N.Y. at 137, 105 N.E. at 823. No questions of receivership were dealt with in the Court of Appeals opinion.

In the *George Godley* action (1916), other wrongful payments were alleged, including counsel fees in an action not identified, but described as seeking appointment of a receiver. The *George Godley* action was dismissed by the Appellate Division for failure to allege demand on the corporation. By way of dictum, the court noted that the judgment under review included an item for fees paid to counsel "in resisting the appointment of a receiver." The court said that the scope of the receivership was "restricted" by the Court of Appeals and that counsel fees in such a matter were properly paid by the corporation. 181 App. Div. at 78, 168 N.Y. Supp. at 254. This language leaves a question whether the Appellate Division got confused into condoning, by dictum, the payment of fees which both it and the Court of Appeals had previously indicated should be borne by the individual defendants, in so far as they represented services performed substantially in defense of the unsuccessful defendants and only nominally in resisting a receivership, or whether fees on the receivership aspects of the *Elizabeth Godley* or some other case were separable from the other fees. In New York Dock Co. v. McCollum, 173 Misc. 106, 112, 16 N.Y.S.2d 844, 849 (Sup. Ct. 1939), the court rejected the argument that a benefit to the corporation results in resisting a receivership "asked for merely as an incidental matter." See Washington, *supra* note 7, at 435-37.

[15] 177 Wis. 627, 189 N.W. 276 (1922).

[16] 256 App. Div. 134, 9 N.Y.S.2d 415 (4th Dep't 1939).

[17] 256 App. Div. at 139, 9 N.Y.S.2d at 420.

The climax of this confusion in the common law was reached in *New York Dock v. McCollum*,[18] in which indemnity was refused in a derivative action, even though defendants were wholly successful. The corporation was willing to pay, but was uncertain of its "power" or "right" to do so in view of the common-law language already described. The court held, without referring to the possibility of any corporate action that might validate assumption of the expenses, that there was no "right" of the insiders to be paid and no "power" in the corporation to assume the obligation in the absence of a corporate "interest." The court could find no such "interest," even in the successful defense of a derivative action.

The statutory reaction to these decisions has developed along three general lines since 1941.[19] The first and least reasoned of these, which is represented by the four "right" states, New York, Wisconsin, Pennsylvania, and Kentucky, was to provide that insiders have a "right" to be reimbursed under all circumstances, except only when there has been "negligence or misconduct" or an unsuccessful defense by the insiders. This reaction, like the common-law cases, fails to give adequate recognition to the different types of action that might be involved, the variety of the allegations that might be at issue, and the area of discretion in which a corporation should be left free, by whatever methods afford suitable protection to minority interests, to commit itself or not to commit itself to indemnify. This approach undertakes to prevent the possible mischarges to insiders, produced by common-law misconceptions, by charging everything to the corporation in all cases, except those that would go to final judgment and that defendants would lose.

The New York statute, which was the first indemnity statute to be enacted, confers the broadest right in one respect: the right is withheld only when the insider has been "*adjudged* liable for negligence or misconduct[20] in the performance of his duties."[21] Wisconsin withholds the right if the insider "*is* guilty of negligence or

[18] 173 Misc. 106, 16 N.Y.S.2d 844 (Sup. Ct. 1939).

[19] For other analyses of the statutes, see Comments, 40 CALIF. L. REV. 104 (1952), 52 MICH. L. REV. 1023 (1954).

[20] The word "misconduct" bears moral overtones, but has no well-understood legal connotation that would facilitate its interpretation in a case, let us say, where the insiders commit or authorize an unlawful act which they believe lawful or about the unlawfulness of which they had no thought at all. WEBSTER'S NEW INTERNATIONAL DICTIONARY (2d ed. 1950) is of little help in defining "misconduct," offering only such adjectives, equally lacking in content, as "bad," "wrong," or "improper" acts or behavior. This word, picked up from the New York statute, is now firmly embedded in most indemnity statutes. It probably came to the New York statute from a draft of a corporation bylaw prepared by corporate counsel. The bylaw proposed in April 1939, the second of 169 analyzed in Bates and Zuckert, *Directors' Indemnity: Corporate Policy or Public Policy*, 20 HARV. BUS. REV. 244, 251 (1941), wherein the phrase "wilful misconduct" is used, could be the anonymous source. The inappropriateness of the concept of "adjudgment" or "guilt" of "misconduct" is emphasized by Schwarz v. General Aniline & Film Corp. 305 N.Y. 395, 113 N.E.2d 533 (1953), in which the statute was held to give a right to indemnity only as to civil actions, and not as to a criminal proceeding for violation of the federal antitrust laws brought jointly against the corporation and certain directors, the individuals having pleaded *nolo contendere*. MODEL BUSINESS CORPORATION ACT § 4(o) was amended in 1957 to make the language of the statute expressly applicable to actions "civil or criminal."

[21] N.Y. GEN. CORP. LAW §§ 64-68 inclusive. (Emphasis added.) An analysis of this statute is made by Bishop, *supra* note 8.

misconduct."[22] This variation from the New York language of "adjudgment" may have been intended to deprive the insider of his right of indemnity if he had been negligent or had misconducted himself and had escaped "adjudgment" by settlement or otherwise.[23] The determination of "guilt" of "negligence" or "misconduct" other than by the "adjudgment" of a court raises so many obvious difficulties, however, that it is doubtful whether the Wisconsin statute effects any practical protection against indemnifying a "guilty" insider who has avoided "adjudgment."

Since the Wisconsin statute contains no other reservations, it confers the most unqualified "right" to indemnity. Provisions in section sixty-seven of the New York statute further qualify the right to an extent not entirely clear. They provide that the court "shall" award indemnity where the defendant has been wholly or partly successful[24] or where the action has been settled with approval of the court. But this language leaves open the question of whether the court may or may not confer a right to indemnity in other situations which do not amount to adjudgment for negligence or misconduct. These provisions are also susceptible to the interpretation that even on a mandatory award, the court has discretion to allow only so much of a reasonable fee as it would deem reasonable to allow under the circumstances;[25] and the New York right is also made expressly subject to inconsistent shareholder action prior to accrual of the alleged cause of action and to inconsistent terms of a court-approved settlement.[26]

The Pennsylvania right is more clearly circumscribed than the other two. The right arises only from the "successful defense" of an action, with express discretion in the court to assess the corporation only such amount as it deems reasonable where the defendants are only partly successful or have settled with the approval of the court.[27]

The Kentucky statute conditions the right where settlement has been effected on approval of the settlement by the board of directors and a "determination" by the board that the defendants were "not guilty of actual negligence or misconduct."[28]

[22] WIS. STAT. § 180.407 (1955). (Emphasis added.). For an analysis of this statute, see Note, 1950 WIS. L. REV. 157.

[23] Consider, for example, Diamond v. Diamond, 307 N.Y. 263, 120 N.E.2d 819 (1954), in which defendant admitted misappropriation and diversion of funds, but successfully moved to dismiss on the grounds of acquiescence and ratification by plaintiff, who was the only other shareholder. The court thought it would be "unconscionable" to prefer one "wrongdoer" over another by letting defendant's expenses be paid by the corporation and plaintiff's not. It "escaped" from this result by ruling that the defendant had been "adjudged" liable, even though there had been no such judgment. The dissent seemed less worried about there having been no adjudgment than it did about there having been, in its opinion, no "misconduct."

[24] "Successful," as used here, has been interpreted not to require success on the merits. Indemnity was allowed in Dornan v. Humphrey, 278 App. Div. 1010, 106 N.Y.S.2d 142 (4th Dep't 1951) after dismissal under the statute of limitations.

[25] N.Y. GEN. CORP. LAW § 64 provides that the applicant for indemnity "shall be entitled to have his reasonable expenses, including attorneys' fees, actually and necessarily incurred . . . assessed against the corporation . . . to the extent provided by section . . . sixty seven. . . ." Section 67 provides that if the applicant was successful in whole or in part or the action has been settled with court approval, "the Court shall grant such application in such amount as it shall find to be reasonable. . . ."

[26] *Id.* § 67 (ii), (iii).

[27] PA. STAT. ANN. tit. 12, § 1323 (1953).

[28] KY. REV. STAT. § 271.375 (1955). See also *id.* § 271.125 (11).

The defendants themselves may not sit as judges in this director-judged determination, and if, for that reason, a quorum of disinterested directors cannot be obtained, the statute provides that a committee of three disinterested shareholders shall make the determination. This extra safeguard may have followed from an express enlargement of the indemnity in Kentucky to include, in addition to costs and expenses, any amount paid in settlement.

Having thus conferred a statutory right of indemnity on the insider, subject only to the reservations set forth in the statutes, these states (except Kentucky) then go on to provide that the statutory right is not exclusive and presumably may be enlarged by articles, bylaws, or directors' resolutions.[29] Unnecessary confusion is introduced by these duplicate provisions. Pennsylvania and Wisconsin, for example, both provide that a corporation has *power* to indemnify insiders, that such "indemnification" is not exclusive, but that it exists only unless the articles provide otherwise. While this qualification appears to invite and honor articles denying indemnity, such articles might well be nullified by the statute conferring indemnity as a "right." Further, if a corporation should exercise its power to confer indemnity narrower in any respect than the statutory "right," the bylaw, article, resolution, or other document so narrowing the indemnity might be held ineffective.[30]

A second and more restrained approach to "correcting" the common-law decisions is made by the Delaware-type statutes, which give express power to the corporation to indemnify insiders not adjudged guilty of negligence or misconduct, but confer no right of indemnity in the absence of corporate action creating it. This approach comes nearest to constituting the "new look" on this subject, if only because it is fashionable. It was adopted, without significant modification, by Rhode Island[31] in 1948, and Maryland[32] and Minnesota[33] in 1951; and it was adopted as part of the completely revised codes of Oregon[34] in 1953, the District of Columbia[35] in 1954, Ohio[36] and Texas[37] in 1955, Puerto Rico[38] in 1956, and Nevada[39] and North Dakota[40] in 1957. It has also been adopted, without significant change, as a part

[29] WIS. STAT. § 180.04 (14) (1955); N.Y. GEN. CORP. LAW § 63; PA. STAT. ANN. tit. 15, § 2852-410 (Supp. 1956). The New York statute is again ambiguous as to whether a vote of shareholders would be required to enact a bylaw or "resolution" providing indemnity.

[30] Wisconsin has vacillated on the need for two separate statutes. In 1949, it repealed the "right" statute, leaving the "power" provision. In 1951, it restored the "right" statute on the theory that indemnity, "if warranted, should be automatic and should not lie in the discretion of directors"; but it kept the "power" provision. WIS. STAT. § 180.407, Revision Committee Note, 1953 (1955).

[31] R.I. Pub. Laws (1948), c. 2154.

[32] MD. ANN. CODE art. 23, § 60 (1951).

[33] MINN. STAT. § 301.09 (7) (1953).

[34] ORE. REV. STAT. c. 57, 030 (15) (Supp. 1955).

[35] D.C. CODE ANN. § 29-904p (Supp. 1956).

[36] OHIO. REV. CODE ANN. § 1701.13 (E) (Page Supp. 1956).

[37] TEX. BUS. CORP. ACT art. 2.02 (16) (1956).

[38] P.R. LAWS ANN. tit., § 202 (10) (Supp. 1956).

[39] NEV. REV. STAT. § 78.070 (6) (Supp. 1957). The wording of this statute makes all powers conferred by statute, including the power to indemnify, subject to limitation in the articles of incorporation.

[40] N.D. Laws 1957, c. 102, § 4 (15).

of the Model Business Corporation Act of the American Bar Association.[41] All these statutes read substantially like the Delaware statute,[42] which is as follows:

Every corporation shall have power to . . .

Indemnify any and all of its directors or officers or former directors or officers or any person who may have served at its request as a director or officer of another corporation in which it owns shares of capital stock or of which it is a creditor against expenses actually and necessarily incurred by them in connection with the defense of any action, suit or proceeding in which they, or any of them, are made parties, or a party, by reason of being or having been directors or officers or a director or officer of the corporation, or of such other corporation, except in relation to matters as to which any such director or officer or former director or officer or person shall be adjudged in such action, suit or proceeding to be liable for negligence or misconduct in the performance of duty. Such indemnification shall not be deemed exclusive of any other rights to which those indemnified may be entitled, under any by-law, agreement, vote of stockholders, or otherwise.

As with many fashions, this approach covers a trouble, but does not eliminate it. It presupposes that the main fault in the common law was its refusal to find a corporate "power" to indemnify and that the way to remedy that fault is to make an express conferral of that power by statute.[43] Actually, the fault of the common law was its failure to recognize and articulate rules for dealing with all the relevant circumstances out of which the indemnity claim arose, and the "no power" talk was only a manifestation of that failure. The Delaware-type statute, by directing itself to the manifestation rather than the cause of difficulty, slays what it thinks is the common-law dragon and leaves the field. The directors themselves then have a free hand to select the means for exercising the power: whether by management decision delegated to it by the directors, simple resolution of the directors, director-passed bylaw, director-approved contracts with insiders, or otherwise. And they are left virtually free to dictate the terms on which indemnity will be granted. Further, the "nonexclusive" clause commonly found in the final sentence of these statutes appears to empower the directors to grant "other and further" indemnity or to give insiders "other rights" under bylaws or other action of directors or shareholders. Does this clause mean that the directors are thus empowered to indemnify insiders on terms other and further than those stipulated in the first part of the section, in which power to indemnify is given so long as negligence or misconduct is not adjudged? If not, what is the purpose of the "nonexclusive" clause? If so, is the effect any less than that insiders are enabled under the statute to adopt any means and terms of indemnity they wish? These questions have yet to be an-

[41] MODEL BUSINESS CORPORATION ACT § 4 (o). A 1957 amendment recognizes the inconsistency in conferring a "power" and then referring, in the last sentence of the statute, to "such *indemnification*." (Emphasis added.) The amendment reads, ". . . and to make any other indemnification which shall be provided for by the articles of incorporation, by-laws, agreement, vote of shareholders, or otherwise." See also note 20 *supra*.

[42] DEL. CODE ANN. tit. 8, § 122 (10) (1953).

[43] Most of the provisions cited in notes 31-41 *supra* are contained in the chapter or section of the corporation statute which deals with the corporate powers.

swered,[44] but, meanwhile, this statutory solution may be said, in the wide discretion it gives to directors and in the ambiguity of its provisions, to contain as much possibility for a mischarge to the corporation as the common law contained for a mischarge to the insider.

The areas in which such a mischarge may be feared under the Delaware approach are best suggested by the statutory provisions of those states which have followed Delaware in part, but have made significant alterations. Three states, Connecticut, Maine, and Virginia, have foreseen situations in which a directors' resolution or a bylaw enacted only by directors, especially where many or most of them were defendants, might fail to protect the minority or corporate interests. It is arguable that this danger can be dealt with after it occurs by invoking the court's equitable powers to find a breach of the insiders' fiduciary obligations, although no case has yet tested the outer boundaries that equity would impose on the insiders' freedom to enact a bylaw permitted by the statute. These states prefer to recognize in advance and deal in the statute with the conflict of interest latent in a director-passed bylaw specifying indemnity terms. A bylaw in Connecticut[45] or bylaw, article, or resolution in Maine,[46] must be enacted by a majority vote of the shareholders. In Virginia, the statute is worded to require some indemnity bylaws to be approved by shareholders, but whether all would require approval is not clear.[47]

The main preoccupation in four other states which have modified the Delaware approach is with the possibility of mischarge to the corporation in settlement. Michigan makes a faint effort to prevent such a mischarge by denying the corporation the power to indemnify in matters "settled by agreement predicated on . . . liability [for negligence or misconduct]."[48] Like the Wisconsin provision for determining guilt other than by adjudgment, this reservation provides no machinery for determining nonadjudged "liability" and is rather unrealistic in supposing that a settlement would contain a recital that it was based upon guilt or liability.

[44] A dictum in Mooney v. Willys-Overland Motors, Inc., 204 F.2d 888, 896 (3d Cir. 1953) suggests that the statute does not control every situation in which indemnification would be appropriate and quotes the "nonexclusive" clause of the statute and a similar "nonexclusive" clause in the bylaw of the corporation which contained indemnity language broader than the indemnity authorized by statute. See note 48 *infra*. Accordingly, a contract indemifying a director who was not a served party in the action was held valid. And in Sorenson v. The Overland Corporation, 242 F.2d 70 (3d Cir. 1957), an indemnity agreement under the same bylaw was held inapplicable, because the court thought that expenses in litigation arising out of defendant's successful defense of compensation arrangements made with him before he became an officer were incurred by him as an individual, "not because he was an officer."

[45] CONN. GEN. STAT. § 5129 (1949). But this statute provides that the section shall not "affect any right to which [the insider] is entitled under any . . . statute, by-law, agreement, vote of stockholders or otherwise," without saying whether the agreement or other basis of indemnity (a director's resolution?) would require stockholders' approval.

[46] ME. REV. STAT. ANN. c. 53, § 24 (1954). Maine has the same proviso as Connecticut referred to in note 45 *supra*.

[47] VA. CODE ANN. § 13.1-3 (n) (Supp. 1956). The statute gives a general power to indemnify by action not specified, but presumably it could be exercised in a bylaw. It then authorizes "other or further indemnity" by articles "or any by-law made by the stockholders."

[48] MICH. COMP. LAWS § 450.10 (1) (1948).

Three states, New Jersey, Montana, and Missouri, deny power to indemnify unless the directors, as in Kentucky, make a determination regarding the fairness of the settlement and the nonadjudged culpability of the defendants. New Jersey provides that it shall be determined by the board, or in any other manner allowed by the articles or bylaws, that the defendant has "not in any substantial way been derelict in the performance of his duties as charged in such action."[49] This determination would call, in many cases, for the possession by laymen directors of considerable sophistication in legal thought and language, extraordinary detachment from the views and interests of their insider-colleagues, and ability of the very highest judicial order.

In recognition of the judicial nature of the duty thus thrust on the directors, Montana permits them to "rely conclusively" on an opinion of independent legal counsel.[50] Both Montana and Missouri add provisions that the director-determination shall not be participated in by the more obviously interested insider who is himself a defendant. In the event that his disqualification makes a quorum impossible, the determination is to be made, in Montana, by a committee of three disinterested shareholders, and in Missouri, by "a committee of three persons appointed by the shareholders."[51]

These variations are interesting not so much for their cumbersomeness, as for their recognition of the danger, which the unvaried Delaware-type statute ignores, of allowing the directors a completely free hand in determining when and on what terms they or their colleague-directors or officers should be indemnified. Other problems of direct conflict in voting by insiders on such benefits as their own compensation, on contracts in which they have a direct or indirect interest, or on the rejection of corporate opportunities later taken by themselves, are recognized in corporation law. They are dealt with by such rules as the requirement of shareholder action or approval, subjection of the transaction in question to review by the court for fairness, or invalidation of the transaction altogether. Even in the absence of direct conflict, the dominant position occupied on many, if not most, boards by full-time employees of the corporation[52] increases the probability of partiality toward the insider in an indemnity decision made by directors.

Even though many boards are not likely to want or need to test the limits of the "nonexclusive" clause by enacting "other and further" indemnity provisions going beyond the specifications in the first part of the statute, unlimited possibilities for doing so are left open by the statute; and at the very least, it is fair to assume that under bylaws enacted in the "new look" states, the insiders are almost invariably

[49] N.J. STAT. ANN. § 14:3-14 (Supp. 1956).

[50] MONT. REV. CODES ANN. § 15-412 (2) (1947). In Montana, as in Kentucky, the indemnification includes any amount paid in compromise. *Cf.* note 28 *supra*.

[51] MONT. REV. CODES ANN. § 15-412 (2) (1947); MO. REV. STAT. § 351.355 (1949).

[52] PAUL W. DICKSON, COMPENSATION AND DUTIES OF CORPORATE DIRECTORS (National Industrial Conference Board Studies in Business Policy No. 16 (1946), found that in 1946, full-time paid officers represented a majority of the boards of half the 535 corporations surveyed. One of ten reported 100% officer boards.

giving themselves a "right" to indemnity as unqualified as any that they can get by statute in a "right" state.[53]

The third type of reaction to the common law is represented by California and North Carolina, the two remaining states which have enacted indemnity provisions. They may both be said to recognize more than the other states the variety of circumstances in each case that are relevant to preventing a mischarge either to the corporation or the insider. The California statute[54] was the first of the two to be enacted and is simplest in its provisions: the whole matter is handed to the court for a completely *ad hoc* determination on each application, and no bylaw, article, resolution, or contract is permitted to have any control over the court's determination. This solution to the complexities of indemnity reflects confidence that the judge who hears the matter will accord proper weight to the various circumstances of the case, and that he is better able to do so than anyone else in an area where he is operating with uncontrolled discretion under a statute, uninhibited by past common-law mistakes. In a sense, this unique and drastically exclusive solution can be regarded as a form of turning back to, or starting over with, the common law.

The effect of the North Carolina statute[55] is, like California's, to leave nothing to the insider and everything to the court in derivative actions in which the insider is partially or wholly successful. The language of "corporate power" is not employed. The insider in a derivative action in which, "or in the settlement" of which, he is partly or wholly successful is entitled to indemnification "for so much of his expenses . . . as the judge . . . finds to be reasonable . . . if . . . the court finds that his conduct fairly and equitably merits such relief." A wholly or partly successful settlement for the defendant, while not defined, would presumably be one where less than the full amount of the relief sought in the complaint was provided by settlement.

The North Carolina statute is the only one that recognizes that different equities might exist in nonderivative actions. It provides separate rules for indemnity in those cases, leaving less to the *ad hoc* discretion of the judge and giving more to the insider than does California, in the way of assurance that business-connected litigation expenses will be borne by the corporation as a matter of course. The insider is given a right of indemnity in nonderivative actions if wholly successful on the merits. If he were successful otherwise than solely on the merits, the statute leaves to the board of directors the determination whether to assume his expenses, but im-

[53] Of 100 representative indemnity provisions adopted by corporations in 1941, there was a "direct grant of indemnity" in ninety-two. The grant in ninety was not exclusive. In ninety-two cases, the primary basis for exception was a judgment of "derelict, liable, negligent, etc." See Bates and Zuckert, *supra* note 20 at appendix. For example, the Willys bylaw adopted in 1946, "purportedly in conformity with the Delaware statute," went beyond the language of the statute. The statutory exception of indemnity for negligence or misconduct appears in the bylaw as an exception for "wilful misfeasance, bad faith, gross negligence or reckless disregard. . . ." Mooney v. Willys-Overland Motors, 204 F.2d 888, 891, n. 5 (3d Cir. 1953). See note 44 *supra*.

[54] CAL. CORP. CODE § 830. For an analysis of this statute, see Ballantine, *California's 1943 Statute as to Directors' Litigation Expenses*, 31 CALIF. L. REV. 515 (1943).

[55] N.C. GEN. STAT. §§ 55-19, 55-20, 55-21 (Supp. 1955).

poses no duty on the directors of making fact-determinations. When he is partly or wholly unsuccessful, he may, nevertheless, be paid if the holders of a majority of disinterested shares so vote at a meeting duly noticed to take such action.

The North Carolina solution, which is made exclusive by the statute,[56] is, thus, the most detailed in recognizing the problems of avoiding a mischarge to either the corporation or the insider and in undertaking to provide rules for resolving them.[57] It deserves careful consideration both by courts and legislatures in those states where no statute has been enacted, as well as in states, such as New York and Connecticut, where revision of the corporation statutes is reported now to be under way.

A consideration of statutes which affect the ultimate burden of litigation expenses would not be complete without reference to the "security-for-expenses" statutes, enacted in the five states of New York, Pennsylvania, Wisconsin, New Jersey, and California,[58] under which insiders' expenses, including attorneys' fees, in derivative actions brought by "small" shareholders may be shifted from the indemnifying corporation to the plaintiff-shareholder.[59] While the indemnification statutes look to the allocation of expenses as a matter of fairness or appropriateness, the security statutes, by imposing a risk on parties known to be in no position to assume it, allocate expenses as a device to deter the initiation of derivative actions by such parties.

As with indemnification, New York led the way. The language of the statute and the impetus for its enactment came from a report on derivative actions by a committee of the New York State Chamber of Commerce in 1944.[60] The premises and conclusions of that report, which are reflected in all but the California statute, were that many "nuisance" or "strike" actions had been brought solely or primarily for their settlement value to the shareholder or their fee value to his attorney, that an action initiated by the holder of shares too small in number to receive substantial benefit from a corporate recovery was probably such an action and was groundless in more cases than not, and that such actions ought to be deterred.[61]

The New York statute was, accordingly, enacted in 1944 to provide that in a derivative action begun by the holder of less than five per cent in number of the outstanding shares, unless their market value exceeded $50,000, security must be

[56] *Id.* § 55-19.

[57] A statute which would undertake "more careful particularization" of the situations in which recovery would be allowed was recommended in a Comment, 40 CALIF. L. REV. 104, 117-18 (1952), before the North Carolina statute was enacted.

[58] The Maryland security-for-expenses provision excludes attorneys' fees. Rule 328b, Maryland Rules of Procedure, MD. ANN. CODE 1415 (Supp. 1957).

[59] For discussions of security-for-expense statutes, see Hornstein, *New Aspects of Stockholders' Derivative Suits*, 47 COLUM. L. REV. 1 (1947); *Should New York's "Security for Expenses" Act Be Amended?* 2 SYRACUSE L. REV. 37 (1951); Pierce, *Security for Expenses in Stockholder's Derivative Actions*, in CURRENT TRENDS IN STATE LEGISLATION 388 (1952); Note, *Security for Expenses Legislation—Summary, Analysis, and Critique*, 52 COLUM. L. REV. 267 (1952).

[60] FRANKLIN S. WOOD, SURVEY AND REPORT REGARDING STOCKHOLDERS' DERIVATIVE SUITS (1944). For a criticism of this report, see Hornstein, *The Death Knell of Stockholders' Derivative Suits in New York*, 32 CALIF. L. REV. 123 (1944).

[61] WOOD, *op. cit. supra* note 60, at 21, 24-25, 33, 36, 47, 76, 112-17.

given for the reasonable expenses, including attorneys' fees, which might be incurred by the corporation and the individual defendants in the action.[62] The statute further provides that the corporation "shall have recourse" to such security in such amount as the court shall determine upon termination of the action. Expenses of the insiders would always be incurred by the corporation and could thus be shifted to such a shareholder whenever the matter ended otherwise than upon "adjudgment for negligence or misconduct" of the individual defendants in the three states of New York, Pennsylvania, and Wisconsin, which have both indemnification-as-a-matter-of-right statutes as well as security-for-expenses statutes. Pending the final outcome, the risk of payment would hang prohibitively over the head of any "small" shareholder, as defined in the statute, who might consider initiating such an action alone or without being joined by others whose holdings aggregated the statutory minimum.[63]

The classification of shareholders who have to post security or pay defendants' fees was enlarged in the three states which soon adopted the New York statute. In 1945, New Jersey enacted a requirement that the holder have more than five per cent of the par or stated capital *value* of all the shares *of every class* in order to escape the security requirement.[64] Pennsylvania[65] and Wisconsin[66] removed the market-value exception, so that the holder of shares in excess of $50,000 would still be required to post security if his holdings were less than the required percentage, which, in Wisconsin, was lowered to three per cent.

Since by far the greater number of the holders of corporate shares in the United States hold less than five per cent or even three per cent in number or value of the outstanding shares and less than $50,000 in aggregate market value,[67] the effect of these statutes in the commercially important states where they have been adopted has been to make the institution of derivative actions by most shareholders practically impossible.[68]

Whatever may have been or may still be the abuses of derivative actions brought

[62] N.Y. GEN. CORP. LAW § 61-b.

[63] If the action is brought in the federal district court in New York, however, all joining plaintiffs must have owned their shares at the time of the transaction complained of, under the holding of Kaufman v. Wolfson, 136 F. Supp. 939 (S.D.N.Y. 1955).

[64] N.J. STAT. ANN. § 14:3-15 (Supp. 1956).

[65] PA. STAT. ANN. tit. 12, § 1322 (1953).

[66] WIS. STAT. § 180.405 (4) (1955).

[67] In 1929, the aggregate holdings of the twenty largest stockholders of the Pennsylvania Railroad amounted to 2.7%; of the American Telephone & Telegraph Company, 4%. ADOLPH A. BERLE, JR. AND GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 47 (1932). A survey of 120 manufacturing corporations having assets of more than $100,000,000 each in 1948 indicated that five out of six holders owned 100 shares or less. *Who Owns "Big Business"?*, 87 TRUSTS & ESTATES 5 (1948). "Random examples" of the market value of a 3% holding of any of nine Wisconsin corporations in 1956 showed the values to be from a minimum of $223,297 to a maximum of $3,466,560. Note, 1956 WIS. L. REV. 322, 325. See number of stockholders and amount of invested capital and assets of 500 largest United States industrial corporations. Fortune, July 1957, the Fortune directory supplement.

[68] See Hornstein, *New Aspects of Stockholders' Derivative Suits*, 47 COLUM. L. REV. 1, 5 (1947).

without adequate grounds, alternatives to curbing these abuses by killing off the action do exist. One is suggested by the California statute.[69] As with indemnification in that state, the matter is left to the supervision and discretion of the court. The statute provides that the court may fix security if the party moving for it establishes a probability in support of the ground that there is no reasonable probability of benefit to the corporation from the action of the security holders.[70]

A similar alternative is suggested by federal securities statutes. The Securities Exchange Act of 1934, without assuming the probability that any action is an abuse, empowers the court, "in its discretion," to assess, or require security for, costs, including attorney's fees, of either party in an action for manipulation of securities prices.[71] This section has been interpreted in a stockholders' derivative action to require the defendant moving for security to assume the burden of showing that the action is being abused.[72] Likewise, the Securities Act of 1933, as amended, gives the court discretion in any action under the Act to require either party to pay or give security for his opponent's expenses, including attorney's fees, if judgment is rendered against the party and if the court believes the unsuccessful action or defense "to have been without merit."[73] And the Trust Indenture Act of 1939 provides that "due regard to the merits and good faith of the claims or defenses" shall govern security and assessment in an action for liability for making a misleading statement[74] and in security and assessment which may be required of holders of less than ten per cent in aggregate amount of indenture securities by agreement of parties to the indenture.[75]

Finally, the Federal Rule of Civil Procedure which requires court approval of any compromise or settlement of a derivative action, with notice to all shareholders,[76] is an effective curb on the secret settlement or "pay-off" of the shareholder that many writers have in mind when they use the term "strike" suit.[77] The prevalence of such settlements in the 1920's and early 1930's undoubtedly gave rise to the federal rule, to the federal statutes, and to many of the abuses decried in the New York report. The adoption of such a rule, instead of a security-for-expenses provision, would leave any shareholder free, without undue risk, to protect the corporation's interests through a derivative action whenever such protection seemed neces-

[69] CAL. CORP. CODE § 834.

[70] For an analysis of the California statute, see Ballantine, *Abuses of Stockholders Derivative Suits; How Far Is California's New "Security for Expenses" Act Sound Regulation?*, 37 CALIF. L. REV. 399 (1949).

[71] 48 STAT. 890, 15 U.S.C. § 78i (e) (1952).

[72] Stella v. Kaiser, 83 F. Supp. 431 (S.D.N.Y. 1949). See also Acker v. Schulte, 74 F. Supp. 683 (S.D.N.Y. 1947).

[73] 48 STAT. 908 (1934), 15 U.S.C. § 77k (e) (1952).

[74] 53 STAT. 1176, 15 U.S.C. § 77www (a) (1952).

[75] 53 STAT. 1172, 15 U.S.C. § 77ooo (e) (1952).

[76] FED. R. CIV. P. 23 (c).

[77] See, *e.g.*, the statement of Governor Edge, of New Jersey, as quoted by Ballantine, *supra* note 70, at 402; Hornstein, *Problems of Procedure in Stockholder's Derivative Suits*, 42 COLUM. L. REV. 574, 590 (1942); Milano, *Security for Expenses in Shareholders' Derivative Suits*, 5 N.Y.U. INTRA. L. REV. 196, 197 (1950); Note, 1956 WIS. L. REV. 322, 323.

sary. The groundlessness of any such action, instead of being assumed, may best be demonstrated by a determined defense by insiders protected in their litigative efforts by appropriate indemnification. Groundlessness may then be dealt with in each case by the usual summary procedures for dealing with groundless actions and by discretionary power in the court to require security or assess costs and expenses.

RECENT LEGISLATION AFFECTING CLOSE CORPORATIONS

F. Hodge O'Neal*

Introducton

Pioneer writers on close corporations[1] lamented the fact that corporation statutes laid down, without differentiation, the same rules for publicly-held and close corporations.[2] They pointed out that the two are utterly different in their nature and in their methods of operation and that concepts and rules suited to the governance of the former are often ill-adapted to the latter. Accordingly, they suggested separate legislation for close corporations—either a completely new statute specially drafted for one-man, family, and other close corporations,[3] or a statute based upon English legislation providing for "private companies."[4]

In spite of the vigor and skill with which these suggestions were presented, however, no jurisdiction in this country has enacted a comprehensive statute setting up separate rules and regulations for close corporations. As a matter of fact, the term "close corporation" is not used at all in corporation statutes. A close corporation is still formed under the same general incorporation laws as a publicly-held corporation, is taxed on the same basis, and in general must conform to the same requirements.

Nevertheless, most modern corporation statutes, especially those which have been enacted or extensively revised since World War II, give an increased flexibility to the corporate form and, to a considerable extent, permit a molding of the corporate device to the needs of closely-held enterprises. Further, in a number of instances, statutory provisions, albeit of rather limited scope, have been enacted with the

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[1] The term "close corporation" has been defined in various ways—as a corporation with a relatively small number of shareholders, as a corporation in which ownership and management are substantially identical, and as a corporation whose shares are not traded on an exchange or an over-the-counter market. One-man companies and family corporations are examples of close corporations, but many close corporations are not owned by one person or a single family.

[2] Weiner, *Legislative Recognition of the Close Corporation*, 27 Mich. L. Rev. 273 (1929); Winer, *Proposing a New York "Close Corporation Law,"* 28 Cornell L.Q. 313 (1943). See also Israels, *The Close Corporation and the Law*, 33 Cornell L.Q. 488 (1948). "It would seem that an intelligent approach to the general problem of incorporation would require at least three types of general incorporation laws in each state: One for the single incorporator, another for the small concern, and a third for the extensive business setup, for purposes of mass production." Rutledge, *Significant Trends in Modern Incorporation Statutes*, 22 Wash. U.L.Q. 305, 339 (1937).

[3] Weiner, *supra* note 2, at 314, 335.

[4] Weiner, *supra* note 2, at 282-84. The "private company" is defined as one which (a) limits membership to fifty, (b) restricts the right to transfer shares, and (c) prohibits any invitation to the public. See L.C.B. Gower, The Principles of Modern Company Law 13 (1954).

primary objective of meeting one or more of the problems peculiar to close corporations; and although the provisions are not by their terms so limited in practical operation, they apply largely, if not exclusively, to close corporations.[5] Mention should also be made of the new North Carolina Business Corporation Act,[6] whose draftsmen, keenly aware of the peculiarities of close corporations, inserted numerous provisions designed to meet their special needs.[7]

This article discusses the provisions in modern corporation statutes which affect close corporations, emphasizing legislative changes made during the last twenty years or so. For this purpose, the legislation is grouped under the following headings: (1) statutes giving the corporate form greater flexibility by authorizing the use of optional charter clauses and special bylaw provisions; (2) statutes authorizing unanimity or high-vote requirements for shareholder and director action; (3) statutes permitting participants in a corporation to depart in various other respects from the traditional pattern of stock corporation management; (4) statutes relaxing the requirements of formal corporate meetings and of strict compliance with traditional corporate ritual; (5) statutes relating to problems of deadlock and dissolution; (6) miscellaneous statutory provisions peculiarly applicable to close corporations; and (7) legislation proposed but not yet enacted.

I

STATUTORY PROVISIONS AUTHORIZING OPTIONAL CHARTER CLAUSES AND SPECIAL BYLAW PROVISIONS

Most modern corporation statutes give a great deal of latitude—much more than is generally supposed—to the lawyer who wants to mold the corporate form to a

[5] The difficulty of defining the close corporation and drawing a sharp line between it and the publicly-held corporation seems to account, in part at least, for the failure to limit the application of some of the new statutes to close corporations. The New York Law Revision Commission, in reporting on section nine of the New York Stock Corporation Law, *infra* note 29, stated: "No satisfactory way of defining the genuine close corporation for purposes of a statute has been found. Economically, the distinction between a close corporation and any other is that in the close corporation management and ownership are substantially identical, but the only way in which it appeared to the commission that a definition could be embodied in a statute would be to limit the amendment to corporations having not more than a stated number of shareholders, or not more than a stated amount of capital. This would necessarily be arbitrary, might not provide an adequate answer to the economic problem, and would possibly permit a single shareholder by splitting up his shareholding to break up the arrangement at will unless the remaining shareholders or the corporation bought him out." N.Y. STATE LAW REVISION COMM'N, REPORT 386 (1948).

Lowndes, *Taxing the Income of the Close Corporation*, 18 LAW & CONTEMP. PROB. 558, 582 (1953), suggests (giving credit for this thought to Professor Elvin R. Latty) that it seems possible "to make a distinction between those corporations whose stock is available to the public through a recognized exchange, or in over the counter markets, and those whose stock does not appear in any recognized market, or cannot be purchased without the consent of the corporate associates."

[6] N.C. GEN. STAT. c. 55 (Supp. 1955). For another recent statute taking a fresh approach to the problems of close corporations, see P.R. LAWS ANN. tit. 14, § 1102 (c) (Supp. 1957) (providing for special management arrangements in a corporation whose certificate of incorporation contains a provision stating that it shall not have more than a specified number of shareholders, the number specified not being greater than eleven).

[7] See Latty, *The Close Corporation and the New North Carolina Business Corporation Act*, 34 N.C. L. REV. 432 (1956); Latty, Powers, and Breckenridge, *The Proposed North Carolina Business Corporation Act*, 33 N.C.L. REV. 26, 45, 51 (1954).

particular business situation. They prescribe general rules for the organization, internal operation, and management of corporations—rules which apply in the absence of a contrary arrangement among the participants; but by and large—though subject to important exceptions in some jurisdictions—they give the participants considerable freedom to regulate internal matters by either charter clause or bylaw provision or by shareholders' agreement.

Almost all the corporation statutes authorize the use of optional charter clauses and special bylaw provisions which supply the draftsman with varied and serviceable materials for setting up a structure suited to the business.[8] Statutory support for such clauses and provisions differs widely among jurisdictions, but the trend has definitely been toward a broader and clearer authorization of the use of those which depart from orthodox patterns.

A. Statutory Provisions Specifically Designating Optional Clauses and Special Provisions

The number and nature of charter or bylaw clauses and provisions authorized by statutory provisions of this sort traverse a broad range. In many states, only two or three clauses and provisions, if any at all, are thus specified; and not uncommonly, these are not the ones that are most needed in close corporations. Nevertheless, among the clauses and provisions expressly designated in one or more jurisdictions are some which can be exceedingly serviceable—such as those granting,[9] defining,[10] or enlarging[11] shareholders' pre-emptive rights to purchase new shares;[12] those imposing restrictions on the transferability of stock;[13] those requiring unanimity or a high vote for shareholder or director action[14] or requiring a high quorum for shareholders' and directors' meetings;[15] those empowering a particular class or designated classes of shares or securities to elect all or a specified number or proportion of the directors;[16] those empowering directors elected by the vote of a particular class or designated classes of shares or securities to elect all or specified officers;[17] and those specifying that no shareholder shall own or vote more than an indicated percentage of the corporation's stock.[18]

[8] See generally O'Neal, *Molding the Corporate Form to Particular Business Situations: Optional Charter Clauses*, 10 Vand. L. Rev. 1 (1956).

[9] *E.g.*, Cal. Corp. Code § 305(b); Pa. Stat. tit. 15, § 2582-204 (11) (1938).

[10] *E.g.*, Md. Ann. Code art. 23, § 26 (1951).

[11] *E.g.*, La. Rev. Stat. § 12-3 (B)(1) (1950).

[12] The participants in a closely-held enterprise will often be interested in preserving or strengthening their pre-emptive rights, because maintenance of their proportionate voting power and their proportionate interest in corporate dividends and preservation of the bargained for divison of control may be of great concern to them.

[13] *E.g.*, Kan. Gen. Stat. Ann. § 17-2803 (F) (1949); Md. Ann. Code art. 23, § 4 (7) (1951); R.I. Gen. Laws Ann. c. 116, § 7 (1938).

[14] *E.g.*, Del. Code Ann. tit. 8, § 102(b) (4) (1953); N.Y. Stock Corp. Law § 9; W. Va. Code Ann. § 3018 (j) (1955).

[15] *E.g.*, N.Y. Stock Corp. Law § 9; Ore. Rev. Stat. §§ 57.165, 57.200 (1953).

[16] *E.g.*, La. Rev. Stat. § 12:34 (D) (1950).

[17] *E.g.*, *id.* § 12:35 (E).

[18] *E.g.*, Kan. Gen. Stat. Ann. § 17-2803 (E) (1949).

B. Statutory Provisions Defining Applicable Rules in Absence of Other Charter or Bylaw Coverage

Statutory provisions of this sort furnish support for a large number of charter clauses and bylaw provisions. An examination of almost any modern corporation statute will reveal numerous sections containing phrases which state that the regulations laid down in the sections are to apply only in the absence of contrary provisions in the charter or bylaws or which otherwise indicate that the subject mattter of the sections may be regulated in the charter or the bylaws.[19] For example, the Illinois Corporation Act provides as follows for charter or bylaw increase in the number of directors required for a quorum or for director action:[20]

> A majority of the board of directors shall constitute a quorum for the transaction of business *unless a greater number is required by the articles of incorporation or the by-laws.* The act of the majority of the directors present at a meeting at which a quorum is present shall be the act of the board of directors, *unless the act of a greater number is required by the articles of incorporation or the by-laws.*

C. Statutory Provisions Broadly Authorizing Any Lawful Clauses and Provisions

Perhaps most helpful of all in supporting charter clauses and bylaw provisions needed in close corporations are broadly-worded statutory provisions. At the beginning of this century, the corporation statutes of a number of states contained a section broadly authorizing the use of optional charter provisions.[21] One of the purposes of such a section was to enable those entering close corporations as minority shareholders to protect themselves by insisting on appropriate safeguards against increases in capital stock, increases in the number of directors, consolidations, and other changes in the corporation's structure or management which might adversely affect their rights.[22]

The number of states with broad statutory authorization of optional charter clauses has steadily grown, until at the present time, the corporation statutes of the great majority, including all the more important commercial jurisdictions, contain such a section. The pertinent section in the Delaware statute,[23] which has identical or quite similar counterparts in a number of jurisdictions,[24] is perhaps typical. It states that the charter may contain:

[19] See, *e.g.*, ILL. REV. STAT. c. 32, §§ 157.14, 157.15, 157.24, 157.25, 157.26, 157.31, 157.33, 157.34, 157.37, 157.38, 157.40, 157.43 (1955).

[20] *Id.* § 157.37. (Emphasis added.)

[21] See, *e.g.*, Ala. Gen. Acts 1903, act 395, § 2 (j); N.Y. Sess. Laws 1895, c. 672, § 10; N.C. Pub. Laws, 1901, c. 2, § 8 (7); Va. Acts of Assembly, Extra Session 1902-04, c. 170, at 437. The National Banking Act of 1864 also contained a provision of this kind. See Bullard v. Banks, 85 U.S. (18 Wall.) 589 (1874).

[22] See Ripin v. United States Woven Label Co., 205 N.Y. 442, 447-48, 98 N.E. 855, 856-57 (1912).

[23] DEL. CODE ANN. tit. 8, § 102 (b) (1) (1953).

[24] See, *e.g.*, ARK. STAT. § 64-101 (i) (1947); FLA. STAT. § 608.03 (1955); GA. CODE ANN. § 22-1082 (h) (Supp. 1956); MD. ANN. CODE art. 23, § 4 (b) (9) (1951); N.J. REV. STAT. § 14: 2-3 (1937). N.Y. GEN. CORP. LAW § 13 (2) provides that a corporation's certificate of incorporation may contain "any provision for the regulation of its business and the conduct of its affairs, and any limitations upon its powers, or upon the rights of its stockholders or upon the powers of its directors and members, which does not exempt them from the performance of any obligation of duty imposed by law."

Any provision which the incorporators may choose to insert for the management of the business and for the conduct of the affairs of the corporation, and any provisions creating, defining, limiting and regulating the powers of the corporation, the directors and the stockholders, or any class of stockholders, or, in the case of a corporation which is to have no capital stock, of the members of such corporation; if such provisions are not contrary to the laws of this State.

Many corporation statutes also contain a section generally authorizing special provisions in the bylaws. The language of these sections is similar to that of some of the sections authorizing optional charter clauses. The Illinois statute, for instance, provides that the bylaws "may contain any provisions for the regulation and management of the affairs of the corporation not inconsistent with law or the articles of incorporation."[25]

Unfortunately, it is not entirely clear exactly what charter clauses and bylaw provisions are sanctioned by these broadly worded statutes. In spite of the expansive language in which these statutes are couched, courts have, on occasion, construed them narrowly and have invalidated unorthodox charter clauses or bylaw provisions on the ground that they are not authorized.[26] Therefore, some authors have cautioned against reliance on these statutes.[27] In view, however, of the general repudiation of the old "concession theory" of corporate existence as inconsistent with the facts of present-day corporate life and the acceptance of the idea that corporate charters and codes of bylaws are primarily contracts among the participants in the enterprises, courts are likely in the future to give a consistently broad and inclusive scope to these statutory authorizations.

II

STATUTORY PROVISIONS AUTHORIZING HIGH-VOTE REQUIREMENTS FOR SHAREHOLDER AND DIRECTOR ACTION

Businessmen forming a close corporation often want a power to veto some or all corporate policies and decisions. In particular, those who are to have minority interests want protection against the broad powers normally vested in shareholders and directors to determine corporate policy and to make decisions by simple majority vote. This desired power frequently can be given by charter clauses or bylaw provisions requiring unanimity or concurrence of a high percentage of voting units for shareholder or director action. Similarly, that power can be given by high-quorum requirement for shareholder and director action: whenever high-quorum requirements exist, a shareholder can prevent shareholder action by refusing to attend shareholders' meetings and can prevent director action by keeping his representative—assuming he has one—away from directors' meetings.[28]

[25] ILL. REV. STAT. c. 32, § 157.25 (1955). See also MO. REV. STAT. § 351.290 (1949).

[26] For a discussion of some of the cases interpreting or applying the general statutes, see O'Neal, *supra* note 8, at 5-19.

[27] See HENRY W. BALLENTINE, CORPORATIONS § 16 (rev. ed. 1946); HENRY W. BALLANTINE AND GRAHAM L. STERLING, JR., CALIFORNIA CORPORATIONS LAWS § 37 (1949).

[28] The use of high-vote and high-quorum requirements to give shareholders a veto over corporate

The statutes authorizing high-vote and high-quorum requirements in the charter or bylaws fall within the broader category of statutes authorizing optional charter clauses and special bylaw provisions, discussed in the preceding section. The serviceability of these requirements in molding the corporate form to the needs of a closely-held enterprise is so great, however, that perhaps attention should be particularly called to typical statutes supporting them.

Undoubtedly the best known of statutory provisions authorizing high-vote and high-quorum requirements is section nine of the New York Stock Corporation Law, enacted originally in 1948 and since amended several times.[29] It expressly provides that the certificate of incorporation can set up high-quorum requirements for shareholders' meetings and for directors' meetings and can require unanimity or a high vote for shareholder or director action. Section nine was enacted on the recommendation of the New York Law Revision Commission to overcome difficulties created for the close corporation by the famous decision of the Court of Appeals of New York in ***Benintendi v. Kenton Hotel***.[30] There, the court held invalid bylaws requiring unanimity for shareholders' resolutions, the election of directors, and directors' resolutions. The reasoning of the court, viz., that the requirements violated statutory norms and that one of the bylaws—the last—was inconsistent with the stautory scheme of corporation management, was broad enough to invalidate the requirements even had they been in the certificate of incorporation rather than in the bylaws. At the time of its passage, section nine was praised as the first important legislative recognition of the distinctive management needs of close corporations.[31]

Although section nine is the statutory provision most often discussed, most states, in fact, now have enacted similar legislation authorizing high-vote and high-quorum requirements for shareholder action, for director action, or for both.[32] An illustrative statutory authorization of charter clauses requiring a high vote for shareholder action is the following widely-prevalent provision:[33]

> Whenever, with respect to any action to be taken by the shareholders of a corporation, the articles of incorporation require the vote or concurrence of the holders of a greater proportion of the shares, or of any class or series thereof, than required by this Act with respect to such action, the provisions of the articles of incorporation shall control.

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action is discussed in some detail in O'Neal, *Giving Shareholders Power to Veto Corporate Decisions: Use of Special Charter and By-Law Provisions*, 18 LAW & CONTEMP. PROB. 451 (1953).

[29] N.Y. STOCK CORP. LAW § 9.

[30] 294 N.Y. 112, 60 N.E.2d 829 (1945).

[31] de Capriles and Reichardt, *1947-1948 Survey of New York Law—Corporations*, 23 N.Y.U.L.Q. REV. 747 (1948).

[32] The statutes are discussed in O'Neal, *Giving Shareholders Power to Veto Corporate Decisions: Use of Special Charter and By-Law Provisions*, 18 LAW & CONTEMP. PROB. 451, 457-60 (1951).

[33] ILL. REV. STAT. c. 32, § 157.146 (1955); MO. REV. STAT. § 351.270 (1949); Tex. Bus. Corp. Act, art. 9.08 (1956); VA. CODE § 13.1-33 (Supp. 1956); MODEL BUSINESS CORPORATION ACT § 136. See also N.C. GEN. STAT. § 55-66 (Supp. 1955); OHIO REV. CODE ANN. § 1701.52 (Page Supp. 1956).

And modern corporation statutes commonly authorize charter clauses or bylaw provisions requiring a high vote for director action as well by stating that:[34]

> The act of the majority of the directors present at a meeting at which a quorum is present shall be the act of the board of directors, unless the act of a greater number is required by this chapter, the articles of incorporation or the bylaws.

III

STATUTORY PROVISIONS PERMITTING DEPARTURE FROM TRADITIONAL MANAGEMENT PATTERNS

The participants in a close corporation often want to depart from the traditional framework of corporation management and to work out among themselves the allocation of control of the business. Although they value the limitation of personal liability the corporate form furnishes, they may want to retain all the freedom of partners in determining who is to control the enterprise and how that control is to be exercised. As has often been noted, shareholders in a close corporation not uncommonly desire to be shareholders to the outside world, but partners among themselves.

The high-vote and high-quorum requirements discussed in the part immediately preceding are departures from the traditional control pattern. But that is only one of the approaches that can be taken to the task of providing the management pattern desired by the participants.[35] Another approach is indicated through variations in the corporation's share structure in the way shares are allocated. In most jurisdictions, statutory provisions governing stock classification and charter clauses on stock and financial matters give the draftsman considerable leeway in this regard.[36] In preparing the stock and financial clauses, the draftsman is not restricted to bare recitals of specified items; he has a wide choice as to the content and wording of the clauses he uses. Thus, by classifying shares, using nonvoting shares or shares with limited voting rights, varying other rights and preferences of the different classes of shares, and carefully parceling out the various classes of shares, almost any desired distribution of control can be obtained.

A third approach that can be followed to effect the desired distribution of control in a close corporation is the use of so-called irrevocable proxies: some of the participants give proxies on some or all of their shares to other participants, empowering the latter to vote the shares for a specified period of time or on stated contingencies. The difficulty with this approach is that in many jurisdictions, there is doubt as to whether proxies for this purpose can be made irrevocable. In general, courts have applied the rules of agency to proxies; and, therefore, in the absence of statute, proxies are usually held to be revocable, unless they are coupled with an interest, and

[34] *E.g.*, ILL. REV. STAT. c. 32, § 157.37 (1955); OHIO REV. CODE ANN. § 1701.62 (Page Supp. 1956); WIS. STAT. § 180.35 (1955); MODEL BUSINESS CORPORATION ACT § 37.

[35] See Ballard, *Arrangements for Participation in Corporate Management Under the Pennsylvania Business Corporation Law*, 25 TEMP. L.Q. 131 (1951).

[36] See, *e.g.*, N.Y. STOCK CORP. LAW § 11.

this is so even though they are in express terms stated to be irrevocable.[37] Further, the concept "coupled with an interest" has proved vague and unhelpful. The courts, on some occasions, have sustained irrevocable proxies in close corporations,[38] and on other occasions, they have held the proxies to be revocable.[39] On the whole, statutes dealing with proxies have done little definitely to settle the question of when—*i.e.*, under what circumstances—and for how long a proxy can be made irrevocable.[40]

In 1953, New York enacted a statutory provision which represents an ambitious effort to draw a clear-cut line between revocable and irrevocable proxies. It provides that a proxy which is entitled "irrevocable proxy" and states that it is irrevocable is irrevocable when it is held by one of the following or his nominee:[41]

(a) a pledgee under a valid pledge;
(b) a person who has agreed to purchase the stock under an executory contract of sale;
(c) a creditor or creditors of the corporation, other than a banking corporation, who extend or continue credit to the corporation in consideration of the proxy if the proxy states that it was given in consideration of such extension or continuation of credit, the amount thereof, and the name of the person extending or continuing credit;
(d) a person who has contracted to perform services as an officer of the corporation, other than a banking corporation, if such a proxy is required by the contract of employment, as part of the consideration therefor, if the proxy states that it was given in consideration of such contract of employment, the name of the employee and the period of employment contracted for.

The statutory provision, however, goes on to remove the attribute of irrevocability as soon as the proxyholder ceases to need protection, by providing that the proxy[42]

> becomes revocable after the pledge is redeemed, or the executory contract of sale is performed, or the debt of the corporation is paid, or the period of employment provided for in the contract of employment has terminated, and becomes revocable, in a case provided for in paragraph (c) or (d) of this section, at the end of the period, if any, specified therein as the period during which it is irrevocable, or three years after the date the proxy was given, whichever period is the lesser, unless the period of irrevocability is renewed from time to time by the execution of a new irrevocable proxy. . . .

Further, the statute states that a provision making a proxy irrevocable is not en-

[37] *In re* Chilson, 19 Del. Ch. 398, 168 Atl. 82, 85 (Ch. 1933); State *ex rel.* Breger v. Rusche, 219 Ind. 559, 39 N.E.2d 433 (1942); Axe, *Corporate Proxies*, 41 MICH. L. REV. 225, 256 (1942).

[38] See, *e.g.*, Smith v. San Francisco & N. Pac. Ry., 115 Cal. 584, 47 Pac. 582 (1897): Ecclestone v. Indialantic, Inc., 319 Mich. 248, 29 N.W.2d 679 (1947); State *ex rel.* Everett Trust & Savings Bank v. Pacific Waxed Paper Co., 22 Wash. 2d 844, 157 P.2d 707 (1945).

[39] See, *e.g.*, Johnson v. Spartanburg County Fair Ass'n, 210 S.C. 56, 41 S.E.2d 599 (1947); Roberts v. Whitson, 188 S.W.2d 875 (Tex. Civ. App. 1945).

[40] Many statutes simply state that a proxy shall not be valid after a specified period of time, unless a longer period is provided for in the proxy. See, *e.g.*, DEL. CODE ANN. tit. 8, § 212 (1953) (three years, unless proxy provides for a longer period); MODEL BUSINESS CORPORATION ACT § 31 (eleven months, unless otherwise provided in the proxy). They do not indicate clearly whether a proxy can be made irrevocable. N.C. GEN. STAT. § 55-68(b) (Supp. 1955) provides that "no proxy, whether or not coupled with an interest or otherwise irrevocable by law, shall be valid after 10 years from the date of its execution."

[41] N.Y. STOCK CORP. LAW § 47-a.

[42] *Ibid.*

forceable against a purchaser of stock without actual notice of the provision, unless notice of the proxy and its irrevocability appears on the certificates representing the affected shares.

Unless a proxy complies fully with the terms of this statutory provision, it will be held to be revocable,[43] despite the fact that under decisions in some other jurisdictions, the particular proxy might be classified as one coupled with an interest. In other words, the New York statutory provision is a two-edged sword—validating some irrevocable proxies, but invalidating others.

Perhaps the most popular approach to the problem of distributing control in close corporations is through a shareholders' agreement. No attempt will be made here to enumerate and discuss the numerous considerations that may influence the decision of a court passing on the validity and enforceability of a typical shareholders' control agreement. Suffice it to say, a high percentage of such agreements contain provisions which are of doubtful validity under the judicial precedents.

The first legislative step to bolster shareholders' agreements and to draw a clear line between valid and invalid agreements was taken in the new North Carolina Business Corporation Act, which contains, among other things, the following provisions:[44]

1. An otherwise valid contract between two or more shareholders that the shares held by them shall be voted as a unit for the election of directors shall, if in writing and signed by the parties, be valid and enforceable as between the parties, but for not longer than ten years from the date of its execution.
2. Except in corporations whose shares are generally traded in the markets, no written agreement to which all the shareholders of a corporation have actually assented, whether embodied in the charter or bylaws or in any side agreement in writing and signed by all the parties, whether it relates to the management of the corporation's business or division of its profits or to any other phase of its affairs, shall be invalid between the parties on the ground that it is an attempt by the parties to treat the corporation as if it were a partnership or to arrange the parties' relationships in a manner that would be appropriate only between partners.
3. An agreement between all or less than all of the shareholders, whether solely between themselves or between one or more of them and a party who is not a shareholder, is not invalid as between the parties on the ground that it so relates to the conduct of the affairs of the corporation as to interfere with the discretion of the board of directors; but (with control properly comes responsibility) the making of such an agreement imposes upon the shareholders who are

[43] N.Y. GEN. CORP. LAW § 19 (3) ("Every proxy shall be revocable at the pleasure of the person executing it, except as otherwise provided in section forty-seven-a of the stock corporation law."); *In re* Norton & Schneider, Inc., 137 N.Y.S.2d 269 (Sup. Ct. 1954) ("irrevocable proxy'" given by one shareholder to another to vote stock in an election of directors held invalid).

[44] N.C. GEN. STAT. § 55-73 (Supp. 1955). See also P.R. LAWS ANN. tit. 14, § 1102 (c) (Supp. 1957) (providing for special management provisions in the certificate of incorporation).

> parties thereto the same liability for managerial acts that is imposed by other provisions of the statute on directors.

Many of the successful attacks on control arrangements departing from the orthodox pattern of corporation management have been based on the argument that such arrangements violate the statutory norm conferring on the board of directors power to manage corporate affairs.[45] The North Carolina statute precludes that ground of attack. In addition to the third provision above, the statute contains a section expressly stating that the norm of director-control shall be subject to modifying provisions in the charter, bylaws, or shareholders' agreements, which reads in part as follows:[46]

> Subject to the provisions of the charter, the by-laws or agreements between the shareholders otherwise lawful, the business and affairs of a corporation shall be managed by a board of directors.

The section goes on to provide, however, that no limitation upon the authority which the directors would have had in the absence of the limitation is effective against persons without actual knowledge of it.[47]

IV

Statutory Provisions Relaxing Requirements of Strict Observance of Corporate Formalities

Corporate rituals and the traditional formalities of corporate operation are often not observed in close corporations. Further, as shareholders and directors are usually the same people, it is not uncommon for the participants to fail to differentiate between what they do as shareholders and what they do as directors. Bylaw requirements are quite often flouted; and, indeed, in some parts of the country, many small close corporations do not have bylaws or even minutes books. There may be a fragmentary file of corporate minutes, but that file will frequently be limited to copies of a few resolutions, such as those required by banks for the opening of checking accounts and those required for the passage of title to real property.

According to traditional corporation doctrine, neither shareholders nor directors can act except at duly called meetings.[48] The courts, however, have repeatedly relaxed the traditional rule in order to sustain informal action taken by participants in close corporations. For instance, they have held that whenever the affairs of a corporation are customarily carried on through informal conferences, decisions reached by *all* the directors and shareholders at an informal conference bind the

[45] See, *e.g.*, Benintendi v. Kenton Hotel, Inc., 294 N.Y. 112, 60 N.E.2d 829 (1945); Manson v. Curtis, 223 N.Y. 313, 119 N.E. 559 (1918).

[46] N.C. Gen. Stat. § 55-24(a).

[47] *Id.* § 55-24(b).

[48] Henry W. Ballantine, Corporations §§ 44, 170 (rev. ed. 1946). Notice of a special directors' meeting must be given to a minority director, even in a close corporation. Lycette v. Green River Gorge, Inc., 21 Wash.2d 859, 153 P.2d 873 (1944).

corporation.[49] Nevertheless, the rule requiring formal shareholders' and directors' meetings poses a serious risk to the validity of action informally taken in a close corporation.

In response to persistent demands from practicing lawyers and organizers of closely-held enterprises, the legislatures are gradually relaxing the traditional requirements of formal corporate meetings. Some modern corporation statutes permit both shareholders and directors to act informally and without a meeting by signing a written consent.[50] Under these statutes, however, unanimity is necessary; *all* the shareholders or directors, as the case may be, must sign for the written consent to be effective.[51] Other statutes expressly permit the shareholders to act by written consent, but do not contain authorization for the directors to act in that way,[52] thus implying that the directors cannot act informally.[53]

Legislative recognition of the informality of corporate meetings is also reflected in a section contained in a number of the new corporation statutes—*e.g.*, the Virginia[54] and Texas statutes[55]—which states that notice of a directors' meeting may be waived after the meeting. This type of statutory provision affords a method for untangling some of the legal snarls that may result from the failure to hold proper meetings.

The new North Carolina Business Corporation Act may well set a pattern for future legislation. It contains elaborate provisions validating informal action by shareholders and directors, provisions avowedly drafted with the needs of the close corporation in mind. Since it may furnish the guide for draftsmen of other states on the subject of informal corporate action, its pertinent provisions are set forth here in full.

Section 55-29 of the Act provides:

> *Informal or irregular action by directors or committee.*—(a) Action taken by a majority of the directors or members of a committee without a meeting is nevertheless board or committee action if:

[49] Brainard v. De La Montanya, 18 Cal.2d 502, 511, 116 P.2d 66 (1941); First Nat'l Bank v. Frazier, 143 Ore. 662, 19 P.2d 1091 (1933); Miller v. South Hills Lumber & Supply Co., 334 Pa. 293, 6 A.2d 92 (1939); National Bank v. Puget Sound Biscuit Co., 61 Wash. 192. 112 Pac. 265 (1910). See also Latty, *A Conceptualistic Tangle and the One- or Two-Man Corporation*, 34 N.C.L. REV. 471, 475 (1956).

[50] *E.g.*, MINN. STAT. §§ 301.26(11), 301.28(7) (1953); PA. STAT. ANN. tit. 15, § 2852-402(5) (Supp. 1956); WIS. STAT. § 180.91 (1955).

[51] The Ohio statute permits informal action by shareholders or directors, but authorizes "contrary" provisions in the articles or the regulations. OHIO REV. CODE ANN. § 1701.54 (Page Supp. 1956). The view has been expressed that the draftsmen of the statute, in referring to contrary provisions, had in mind provisions limiting shareholder and director action to action taken as a group at a formal meeting, and that they did not intend to permit the participants to provide in the articles or the regulations for action without a meeting upon the written approval of *less than all* of the shareholders or directors. See Dampeer, *General Corporation Law and Non-Profit Corporation Law*, 16 OHIO ST. L.J. 446, 480 (1956).

[52] *E.g.*, DEL. CODE ANN. tit. 8, § 228 (1953); MODEL BUSINESS CORPORATION ACT § 138.

[53] In jurisdictions in which the board cannot act by written consent, inconvenience to the whole board can sometimes be avoided by setting up an executive committee with authority to act for the board. Many corporation statutes contain a provision expressly authorizing creation of an executive board.

[54] VA. CODE ANN. § 13.1-27 (Supp. 1956).

[55] TEX. BUS. CORP. ACT art. 9.09 (1956).

(1) Written consent to the action in question is signed by all the directors or members of the committee, as the case may be, and filed with the minutes of the proceedings of the board or committee, whether done before or after the action so taken, or if

(2) All the shareholders know of the action in question and make no prompt objection thereto, or if

(3) The directors or committee members are accustomed to take informal action and this custom is known to all the shareholders and if all the directors or committee members, as the case may be, know of the action in question and no director or committee member makes prompt objection thereto.

(b) If a meeting of directors otherwise valid is held without proper call or notice, action taken at such a meeting otherwise valid is deemed ratified by a director who did not attend unless promptly after having knowledge of the action taken and of the impropriety in question he files with the secretary or assistant secretary of the corporation his written objection to the holding of the meeting or to any specific action so taken.

Section 55-63 of the Act provides:

Irregular meetings; action without meetings.—(a) The transaction of any meeting of shareholders, however called and with whatever notice, if any, are as valid as though had at a meeting duly held after regular call and notice, if:

(1) All the shareholders entitled to vote are present in person or by proxy and no objection to holding the meeting is made by any shareholder, or if,

(2) A quorum is present either in person or by proxy and no objection to holding the meeting is made by anyone so present, and if, either before or after the meeting, each of the persons entitled to vote, not present in person or by proxy, signs a written waiver of notice, or a consent to the holding of the meeting, or an approval of the action taken as shown by the minutes thereof. All such waivers, consents, or approvals shall be filed with the corporate records or made a part of the minutes of the meeting.

(b) The absence from the minutes of any indication that a shareholder objected to holding the meeting shall prima facie establish that no such objection was made.

(c) Any action which, under any provisions of this chapter, may be taken at a meeting of the shareholders, may be taken without a meeting if consent in writing, setting forth the action so taken, shall be signed by all of the persons who would be entitled to vote upon such action at a meeting and filed with the secretary of the corporation as part of the corporate records. Such consent shall have the same force and effect as a unanimous vote of shareholders, and may be stated as such in any certificate or document filed with the Secretary of State under this chapter.

V

STATUTORY PROVISIONS RELATING TO PROBLEMS OF DEADLOCK AND DISSOLUTION

A. Statutory Provisions Permitting Special Contractual Arrangements for Corporate Dissolution

Dissension among the shareholders falls with a heavy impact in a close corporation. A large part of the assets of some or all of the shareholders may be tied up in the company, and salaries received from employment by the company may furnish their principal livelihood. Not uncommonly, each of the shareholders is guaranteed membership on the board of directors and a particular office by a shareholders' agree-

ment. As the shareholders are active in the business, they are in constant contact with each. Because of this intimacy, once dissatisfaction or distrust has developed, friction is likely to continue to grow.

In the close corporation, the relationship between the participants, like that among partners, is one which requires close cooperation and a high degree of good faith and mutual respect; but, when these conditions are absent, a participant does not have a partner's power to dissolve the business unit and get out.[56] At the same time, the "way out" which is open to a shareholder in a publicly-held corporation, too, is not available to a participant in a close corporation. In a publicly-held corporation, a shareholder who is dissatified with the way in which the corporation is being operated can sell his shares at no great financial loss; but shares in a close corporation cannot be so easily disposed of. Anything less than a controlling interest in a close corporation does not have a ready market; and, if there is dissension in the corporation, a minority interest is likely to appear even less inviting to a prospective purchaser. Further, if there are restrictions on the transferability of shares, as is often the case, an irritated and obstinate associate is in a position to prevent the sale of the shares.

Whenever a shareholder in a close corporation wants to get out but cannot dispose of his shares without heavy financial loss, there often develops a state of affairs which is sometimes referred to as a "stalemate."[57] A dissatisfied shareholder's service may be necessary for the efficient operation of the business, or he may be frozen into the directorate and into an officership by a shareholders' agreement or other control arrangement. But in exasperation, he may consistently refuse to cooperate with his associates; in fact, he may do whatever he can to obstruct the operation of the corporation's affairs. The strife among the participants not infrequently results in incessant litigation and perhaps even in physical violence.[58] This state of affairs, of course, harms the enterprise and results in serious losses to all shareholders.

But perhaps even more serious, "deadlocks" frequently occur among the shareholders and in the directorates of close corporations. The distribution of voting shares in close corporations is often such that an eventual impasse is possible or even probable. Such, for example, may be the case where the shares are equally divided

[56] A partner may bring about the dissolution of the firm at any time. See UNIFORM PARTNERSHIP ACT §§ 31(1)(b) (dissolution without violation of the partnership agreement by "the express will of any partner when no definite or particular undertaking is specified"), § 31(2) (dissolution in contravention of the agreement by the express will of any partner at any time). See also *id.* § 32, providing that on application by or for a partner, "the court shall decree a dissolution whenever: (a) A partner has been declared a lunatic in any judicial proceeding or is shown to be of unsound mind, (b) A partner becomes in any other way incapable of performing his part of the partnership contract, (c) A partner has been guilty of such conduct as tends to affect prejudicially the carrying on of the business, (d) A partner wilfully or persistently commits a breach of the partnership agreement, or otherwise so conducts himself in matters relating to the partnership business that it is not reasonably practicable to carry on the business in partnership with him, (e) The business of the partnership can only be carried on at a loss, (f) Other circumstances render a dissolution equitable."

[57] See Israels, *The Sacred Cow of Corporate Existence: Problems of Deadlock and Dissolution*, 19 U. CHI. L. REV. 778, 781 (1952).

[58] See, *e.g.*, Stott Realty Co. v. Orloff, 262 Mich. 375, 247 N.W. 698 (1933); Nashville Packet Co. v. Neville, 144 Tenn. 698, 235 S.W. 64 (1921).

between two shareholders or groups of shareholders. Again, wherever directorates have an even number of members—not an uncommon occurrence—even divisions among the directors may well arise. Further, those who are to hold minority interests in closely-held enterprises, in an effort to protect themselves against the power normally vested in shareholders and directors to determine corporate policy and to make decisions by simple majority vote, often bargain for and obtain a veto over corporate policies and decisions. The granting of veto powers to some or all of the shareholders, of course, also greatly enhances the risk of corporate paralysis. In the colorful language of a Virginia court, these veto arrangements enable a recalcitrant shareholder or director to "embalm his corporation and hold it helpless . . . in a state of suspended animation."[59]

It may be advisable, therefore, in some close corporations, to set up special provisions for dissolution in the charter or bylaws or in a shareholders' agreement. Each shareholder might be given the power, similar to that of a partner, to obtain the dissolution of the concern at will, or if he first offers his shares to the other shareholders at a predetermined price and they do not purchase. Or provision might be made for compulsory dissolution of the corporation on the occurrence of specified events—*e.g.*, the death or disability of any shareholder or of a particular shareholder, or the failure of the corporation to pay dividends in a specified amount for a named period of time. Another provision that might be useful in a shareholders' agreement is one binding all the shareholders to vote their shares for dissolution if a deadlock develops among the shareholders or directors and persists for a stated period of time, or if the terms of the directors expire and for a designated time the shareholders are unable to elect new directors.

On the other hand, provisions might also be included to make dissolution more difficult than it would otherwise be. For instance, a unanimous vote of the shareholders might be required for dissolution to protect minority shareholders against the possibility of a freeze-out in which majority shareholders would obtain the dissolution of the corporation and then take the business and its assets into another company in which the minority shareholders would have no interest.

There is serious doubt whether special dissolution arrangements will be given effect in jurisdictions where statutes fixing the shareholder vote and spelling out procedures for dissolution are couched in language that may be interpreted as mandatory. In the few instances in which a special dissolution provision has been challenged, however, it has been sustained by the courts. Thus, a Georgia court sustained a contract by which a shareholder promised to vote his stock for dissolution in consideration of another shareholder's undertaking to reimburse the promissor if the amount the promissor received from the liquidation was less than the sum he originally paid for his shares.[60] And an agreement among the two shareholders of

[59] Kaplan v. Block, 183 Va. 327, 31 S.E.2d 893, 896-97 (1944).

[60] Wolf v. Arant, 88 Ga. App. 568, 77 S.E.2d 116 (1953). See also Simonson v. Helburn, 97 N.Y.S.2d 406 (Sup. Ct. 1950). *But cf.* Flanagan v. Flanagan, 273 App. Div. 918, 77 N.Y.S.2d 682 (2d Dep't 1948), *aff'd mem.*, 298 N.Y. 787, 83 N.E.2d 473 (1948).

a corporation prohibiting either from bringing about the dissolution of the corporation except in ways specified in the agreement was given effect by a Massachusetts court, even though a statute provided that a corporation or its members might file for dissolution under circumstances different from those set forth in the agreement.[61]

The new North Carolina Business Corporation Act is designed to dispel any doubt about the validity of contractual arrangements for dissolution. That statute authorizes judicial liquidation of a corporation in an action by one of its shareholders whenever it is established that all of the shareholders[62]

> . . . are parties to, or are transferees or susbcribers of shares with actual notice of a written agreement, whether embodied in the charter or separate therefrom, entitling the complaining shareholder to liquidation or dissolution of the corporation at will or upon the occurrence of some event which has subsequently occurred.

Query, however, whether this statute authorizes a court to enforce an agreement making dissolution more difficult to accomplish than it would otherwise be, and to refuse dissolution, otherwise called for, on the ground that it would be contrary to the agreement among the participants.

Some of the statutory materials authorizing unanimity or high-vote requirements for shareholder and director action[63] would probably support charter clauses or special bylaw provisions giving shareholders a veto over decisions to dissolve by requiring unanimity for dissolution. Further, Iowa has a statute which states specifically that a corporation may be dissolved "in accordance with the provisions of its articles";[64] and Massachusetts has one which provides that the agreement of association may contain a provision for the corporation's voluntary dissolution.[65]

B. Dissolution-on-Deadlock Statutory Provisions

Many jurisdictions, including practically all the more important commercial and industrial states, have statutory provisions specifically authorizing corporate dissolution in situations of deadlock in director or shareholder voting. There is considerable variation among these jurisdictions in the statutory language and some differences in the kinds of deadlock situations covered. The statutes discussed in the following paragraphs perhaps illustrate most of the variations.

The New York statute[66] authorizes dissolution in the following situations:

[61] Leventhal v. Atlantic Finance Corp., 316 Mass. 194, 55 N.E.2d 20 (1944).

[62] N.C. GEN. STAT. § 55-125(3) (Supp. 1955).

[63] See *supra* 345-47.

[64] IOWA CODE § 491.23 (1954). As statutory provisions setting a particular shareholder vote for dissolution are designed to protect the shareholders, rather than the public generally, a strong argument can be made that even without specific statutory authorization, the shareholders can waive, limit, or contract away their rights under those statutes. See Annot., 154 A.L.R. 269, 270 (1945). For a discussion of New York statutes relating to dissolution and of the possibility of restricting the statutory right of the holders of a majority of the shares to seek a voluntary dissolution, see Note, 1 SYRACUSE L. REV. 489 (1950).

[65] MASS. ANN. LAWS c. 156, § 6(h) (1948).

[66] N.Y. GEN. CORP. LAW § 103. See generally on deadlock-dissolution problems in New York, Comment, 50 COLUM. L. REV. 100 (1950); Note, 27 N.Y.U.L. REV. 300 (1952); Burstein, *The Dissolution of Closed Corporations*, 123 N.Y.L.J. 1464, 1484, 1504 (April 26-28, 1950).

1. A corporation has an even number of directors who are equally divided respecting the management of its affairs.

2. The votes of a corporation's stockholders are so divided that they cannot elect a board of directors.

3. A corporation's certificate of incorporation requires a vote for director action greater than otherwise would be required by law, and the directors are divided respecting the management of the corporation's affairs in such a way that the requisite number of votes for action by the board of directors cannot be obtained; or a corporation's certificate of incorporation requires a stockholder vote for election of directors greater than otherwise would be required by law, and the votes of the stockholders are so divided that the requisite number of votes for election of directors cannot be obtained.

An important restriction on a court's right to dissolve under the New York statute is that it must appear that the dissolution will be beneficial to the stockholders and not injurious to the public.[67] This requirement has been applied by the Court of Appeals to deny dissolution of a deadlocked corporation if it is operating profitably.[68]

The deadlock statute in a number of states provides for dissolution whenever it appears that[69]

> . . . the directors are deadlocked in the management of corporate affairs and the shareholders are unable to break the deadlock, and that irreparable injury to the corporation is being suffered or is threatened by reason thereof.

The Illinois statute authorizes dissolution on that ground or on the ground, which was added to the statute in 1951, that[70]

> . . . the shareholders are deadlocked in voting power, and have failed, for a period which includes at least two consecutive annual meeting dates, to elect successors to directors whose term has expired or would have expired upon the election of their successors.

This ground for dissolution, in that it propounds a standard that is definite and yet gives the participants a reasonable time to settle their differences, affords a sensible and workable basis for dissolution, and it is encouraging to note this ground is gaining widespread acceptance.[71]

[67] N.Y. GEN. CORP. LAW § 117; *In re* Seamerlin Operating Co., Inc., 307 N.Y. 407, 121 N.E.2d 392 (1954); *In re* Radom & Neidorff, Inc., 307 N.Y. 1, 119 N.E.2d 563 (1954); Application of Cantelmo, 275 App. Div. 231, 88 N.Y.S.2d 604 (1st Dep't 1949) (dissolution will not be granted as beneficial to stockholders where petitioner is seeking to oust other stockholder from the business); *In re* Norton & Schneider, Inc., 137 N.Y.S.2d 269 (Sup. Ct. 1954) (court recognized that its refusal to dissolve meant that the corporation would have to function for an indefinite time with a holdover board because the shares were evenly divided and could not elect a new board, but it denied dissolution because there had been no showing that dissolution would benefit the shareholders).

[68] *In re* Radom & Neidorff, Inc., 307 N.Y. 1, 119 N.E.2d 563 (1954).

[69] *E.g.*, ILL. REV. STAT. c. 32, § 157.86 (a) (1) (1955); MO. REV. STAT. § 351.485 (1949); PA. STAT. tit. 15, §§ 2852-1107 (A) (4) (1938). *Cf.* IND. ANN. STAT. § 25-242 (6) (1948) (the "shareholders or directors are deadlocked in the management of the corporate affairs, and the corporation is suffering or is about to suffer, irreparable injury by reason thereof").

[70] ILL. REV. STAT. c. 32, § 157.86 (a) (2) (1955).

[71] Among the corporation statutes which contain a provision of this kind are: N.C. GEN. STAT. § 55-125 (a) (2) (Supp. 1955); WIS. STAT. § 180.771 (1) (a) (4) (1955).

The California statute[72] authorizes a court to entertain proceedings for the involuntary winding-up or dissolution of a corporation on any one of a number of grounds including the following:

> 1. The corporation has an even number of directors who are equally divided and cannot agree as to the management of its affairs, so that its business cannot longer be conducted to advantage or so that there is danger that its property or business will be impaired and lost.
> 2. The holders of the voting shares of the corporation are so divided into fractions that they cannot agree upon or elect a board of directors consisting of an uneven number.
> 3. There is internal dissension and two or more factions of shareholders in the corporation are so deadlocked that its business cannot longer be conducted with advantage to its shareholders.

Most of the deadlock statutory provisions clearly cover a situation in which a board with an even number of members divides equally and the shareholders cannot resolve the deadlock by election of a new board because the shares are evenly divided between two shareholders or two factions. Some of the statutes, however, apparently do not authorize the dissolution of a corporation which is deadlocked because the charter or bylaws of the corporation require unanimity or a high vote director or shareholder action and no faction can get the necessary vote; or, if they do authorize dissolution in such a situation, they do not permit a shareholder with relative small holdings to bring the petition. Thus, the Massachusetts statute[73] does not permit a petition for involuntary dissolution to be filed on the basis of deadlock except by the holder or holders of not less than forty per cent of the corporation's stock, and then only if the votes of the corporation's board of directors and of its stockholders

> . . . are *equally* divided on a question affecting the general management of the affairs of the corporation, or if the votes of its stockholders are *equally* divided in the election of directors, and there appears to be no way of reaching an agreement and breaking such deadlock.

On the other hand, some statutes are broad enough unequivocally to authorize dissolution where deadlock is brought about through the operation of high-vote or high-quorum requirements.[74]

C. Statutory Provisions Allowing a "Buy-Out" As Substitute for Dissolution

A few states have statutory provisions which empower majority shareholders, whenever dissatisfied minority shareholders bring a suit for the dissolution or winding up of the corporation, to avoid the dissolution by purchasing the shares of the dissatisfied shareholders at their fair value, as determined by a prescribed pro-

[72] CAL. CORP. CODE § 4651 (b-d).
[73] MASS. ANN. LAWS c. 155, § 50 (1948). See also N.J. REV. STAT. § 14:13-15 (Supp. 1955).
[74] MINN. STAT. § 301.49 (4) (1953); N.Y. GEN. CORP. LAW § 103.

cedure.[75] This buy-out provision is desirable, because it permits majority shareholders to preserve the enterprise as a going business and, at the same time, guarantees a dissatisfied shareholder a fair price for his holdings.

Perhaps dissolution-on-deadlock statutory provisions could be improved by specifying that whenever a deadlock results from the operation of high-vote or high-quorum requirements for shareholder and director action, rather than from an equal division of shareholders and directors, majority shareholders will have an option to purchase the minority shareholders' interest at a price determined in a specified way. As a matter of fact, consideration might well be given to provisions empowering each shareholder or faction in a corporation deadlocked by an even division to set a value on a half-interest in the enterprise, which the opposing parties would then have to give for the offeror's interest or accept for their own interest.

VI

MISCELLANEOUS STATUTORY PROVISIONS APPLICABLE TO CLOSE CORPORATIONS

A. Texas Statutory Provision Dealing With Restrictions on the Transferability of Shares

Participants in a close corporation often want the power to choose their future business associates. That power is commonly given to them by placing restrictions on the transferability of the corporation's shares of stock. By far the most popular restrictions in this country are the so-called "first option," which gives the corporation or the other shareholders first refusal of the shares of a holder who decides to sell and sometimes an option to purchase the shares of a holder who dies or leaves the employment of the company; and buy-and-sell arrangements, which require the estate of a deceased shareholder to sell and the corporation or the surviving shareholders to buy the deceased's interest in the company.

As a general proposition, the courts, in the absence of statutory provisions to the contrary, sustain restrictions which they think are "reasonable" in the light of all the circumstances of the particular case,[76] irrespective of whether the restrictions are in the charter, the bylaws, or a shareholders' agreement. With very few exceptions, the courts have upheld first options and buy-and-sell arrangements. Under the Uniform Stock Tranfer Act,[77] however, a restriction will not be given effect, at least as to purchasers without knowledge of it, unless it is stated on the share certificates affected.

A section of the new Texas Business Corporation Act is unique, in that it attempts a legislative statement on the validity of share transfer restrictions. In general, the statutory provision follows the rules laid down by the judicial decisions and the Uniform Stock Transfer Act. It provides first that a corporation[78]

[75] CONN. GEN. STAT. § 5228 (1949); CAL. CORP. CODE §§ 4658-59; W. VA. CODE ANN. § 3093 (1955).
[76] See Annot., 2 A.L.R.2d 745 (1948); O'Neal, *Restrictions on Transfer of Stock in Closely Held Corporations: Planning and Drafting*, 65 HARV. L. REV. 773, 777-784 (1952).
[77] UNIFORM STOCK TRANSFER ACT § 15.
[78] TEX. BUS. CORP. ACT art. 2.22 (1956).

> . . . may impose restrictions on the sale or other disposition of its shares and on the transfer thereof, which do not unreasonably restrain or prohibit transferability, if each such restriction is expressly set forth in the articles of incorporation or by-laws of the corporation and is copied at length on the face or so copied on the back and referred to on the face of each certificate representing shares. . . .

It then goes on to state that in addition to any other restrictions which may reasonably be imposed on the transfer of its shares by any corporation under the above provision, the following restrictions may be imposed:[79]

> (1) Restrictions reasonably defining pre-emptive or prior rights of the corporation or its shareholders of record to purchase any of its shares offered for transfer.
>
> (2) Restrictions reasonably defining rights and obligations of the holders of shares of any class, in connection with buy-and-sell agreements binding on all holders of shares of that class, so long as there are no more than twenty holders of record of such class.
>
> (3) Restrictions reasonably defining rights of the corporation or of any other person or persons, granted as an option or options or refusal or refusals on any shares.

The following points about the Texas statute should be particularly noted. First, it limits the use of buy-and-sell agreements to classes of stock which are held by twenty persons or less. Query, whether this limitation is desirable as a matter of policy; the use of buy-and-sell agreements to restrict classes of stock which are widely-held may lead to complications, but whether a buy-and-sell agreement is to be used in any particular situation might well be left to the business judgment of the persons involved. Second, its wording raises some doubt whether restrictions other than buy-and-sell arrangements are valid if placed in a shareholders' agreement, rather than in the charter or bylaws. Third, it does not attempt to settle the question of whether "consent restraints"—*i.e.,* restrictions requiring the approval of the directors or the shareholders for a transfer of shares—are "reasonable" and, thus, valid. Fourth, it does answer one question that has perhaps never been settled by the cases—namely, whether first options on shares may be granted to persons other than the corporation or its shareholders; the answer is in the affirmative.

B. Statutory Provisions Empowering Directors to Fix Their Own Compensation as Directors and Officers

One of the most difficult problems in a close corporation is to find a method of fixing executives' compensation which will not later be subject to attack. As majority shareholders in a close corporation are usually its controlling directors and principal officers, a disinterested quorum of directors to pass resolutions on executives' salaries often cannot be obtained.

In 1951, Wisconsin enacted what was then unique legislation designed to solve the problems involved in fixing the compensation of corporate officers and execu-

[79] *Ibid.* Subject to minor changes in capitalization and punctuation, the language which follows in the text is that of the statute.

tive employees when those officers and employees constitute a majority of the board of directors.[80] In brief, the directors are given the power to establish reasonable compensation for officers and employees, irrespective of any personal interest of the directors. In 1955, a similar statutory provision was adopted in Ohio.[81] The Wisconsin statute reads in full as follows:

> Unless otherwise provided in the articles of incorporation or by-laws, the board of directors, by the affirmative vote of a majority of the directors then in office, and irrespective of any personal interest of any of its members, shall have authority to establish reasonable compensation of all directors for services to the corporation as directors, officers or otherwise, or to delegate such authority to an appropriate committee. The board of directors also shall have authority to provide for or to delegate authority to an appropriate committee to provide for reasonable pensions, disability or death benefits, and other benefits or payments, to directors, officers and employees and to their estates, families, dependents or beneficiaries on account of prior services rendered by such directors, officers and employees to the corporation.

Note that the statute clearly states that the compensation must be reasonable. The proponents of this legislation contend that while a shareholder can still bring a suit based on the claim that director-employees are engaging in self-dealing in fixing their own compensation, the result reached in the litigation will turn on the reasonableness of the director-employees' compensation, and not on a technical defect in the corporate action fixing the compensation.[82] The second sentence in the Wisconsin statute was designed to answer any doubt of the power of the directors to grant reasonable benefits or additional compensation to executives or other employees based on their past services, or to grant pensions or allowances to the widows or dependents of executives or other employees.

VII

LEGISLATION PROPOSED BUT NOT ENACTED

Perhaps a few words should be said about legislative proposals which have been advanced recently with problems of special importance to close corporations in mind, but which thus far have not been enacted. Two proposals have been made with a view to protecting minority shareholders against self-serving and selfish action by majority interests. A bill introduced in New Jersey a few years ago would have limited the discretion of the board of directors by requiring a declaration of dividends whenever the earned surplus of a corporation having one class of stock becomes "greater than ten times the par value of its capital stock issued and outstanding, or ten times the amount subscribed for and paid in on the capital stock of the company if the same be of no par value," unless holders of two-thirds of the shares

[80] WIS. STAT. § 180.31 (1955).
[81] OHIO REV. CODE ANN. § 1701.60 (Page Supp. 1956).
[82] See comments of the draftsmen in the accompanying annotations. *Ibid.* See also Dampeer, *supra* note 51, at 481.

consent to the withholding of dividends.[83] This would have enabled minority shareholders who could muster the votes of over one-third of the shares to defeat schemes by majority interests designed to freeze-out the minority by withholding dividends indefinitely, while perhaps paying comfortable compensation to majority shareholders in officerships.

The new North Carolina Business Corporation Act, as originally proposed, contained a subsection, omitted in the statute as finally enacted,[84] which afforded a remedy to minority shareholders if the controlling shareholders should try to dilute the proportionate interests of the minority by causing new shares to be issued at less than their value to themselves or their relatives or friends.[85] Pre-emptive rights, even assuming that they have not been denied by special charter or bylaw provision, do not always protect minority shareholders against that possibility, because new shares may be issued, perhaps designedly, at a time when minority shareholders cannot finance their acquisition of new shares. The subsection omitted from the North Carolina statute provided expressly that a pre-emptive offer to a shareholder of his pro rata part of new shares or treasury shares would not deprive him of a cause of action based on the issuance of the shares at a price which unfairly diluted his holdings, if there was no ready and adequate market for the sale of his rights under the offer and if he notified the corporation in writing that he was financially unable to accept the offer and that he believed the offering price to be so low as unfairly to dilute his holding. The subsection went on to provide that in an action of this type, evidence tending to show prior efforts to induce the shareholder to sell his shares to directors, officers, or dominant shareholders of the corporation would put upon the defendant or defendants the burden of proving that the offering price was fair.

The proposal that would have perhaps the most significant effect of all on close corporations, were it to be adopted, is the one that would treat close corporations as partnerships for income tax purposes. Professor Charles L. B. Lowndes argues convincingly that in close corporations, the separate corporate entity should be disregarded and the shareholders taxed directly upon their distributive shares of the corporate income in the same way that the income of a partnership is taxed to the partners.[86] Somewhat along these lines, the Internal Revenue Code of 1954, at the time it was introduced, contained a provision which would have permitted, subject

[83] S. 273 (1955), discussed in Note, 10 RUTGERS L. REV. 723 (1956). An earlier New Jersey statute contained language which seemed to require dividend payments by the directors, but Stevens v. United States Steel Corp., 68 N.J. Eq. 373, 59 Atl. 905 (Ct. Err. & App. 1905), imposed limiting conditions which rendered the provision ineffective, and it was later repealed. A number of states now have or have had legislation similar to the old New Jersey statute. See, *e.g.*, N.M. STAT. ANN. c. 51, § 3-16 (1953); N.C. GEN. STAT. § 55-115 (1950), abrogated by N.C. GEN. STAT. § 55-50(j) (Supp. 1955).

[84] S. 49, § 55-46 (h) (1955).

[85] For a discussion of freeze-outs of minority shareholders by the bad faith issuance of additional shares, see Note, 35 N.C.L. REV. 271 (1957).

[86] Lowndes, *supra* note 5, at 581. Proposals to class small corporations as partnerships for income tax purposes were made as early as 1928. See Weiner, *supra* note 2, at 283-84.

to certain conditions and limitations, a close corporation to elect to be taxed as a partnership;[87] but that provision was eliminated in the conference committee.[88]

CONCLUSION

Many, if not most, modern corporation statutes are sufficiently elastic in their provisions that informed lawyers can mold the corporate device to meet the principal needs of a closely-held enterprise, although careful planning and resourceful and imaginative drafting are essential to accomplish that objective. Further, a number of statutes of limited scope have tackled problems which are peculiar to, or at least most acute in, close corporations, and the prophecy can safely be made that there will be an even greater legislative recognition of close corporations problems in the future.[89]

This legislative recognition probably will not take the form of a separate statute laying down comprehensive regulations applicable solely to close corporations. Perhaps a separate statute would be undesirable, in that it would tend to discourage the expansion of close corporations into publicly-held ones. In any event, most members of the corporate bar seem to be opposed to a separate statute. Future developments in statutes affecting close corporations rather may well follow the innovations in the new North Carolina Business Corporation Act. Draftsmen charged with revising the corporation laws of other states should seriously study that imaginative and carefully-drafted legislation.

The taxation of close corporations on the same basis as partnerships would eliminate some of the tax-avoidance schemes now so widely prevalent and would permit many corporate decisions which are now based primarily on tax considerations to be made solely on the basis of business considerations. That change also might encourage the initiation and growth of small enterprises. Eventual modification of the tax laws to tax close corporations as partnerships is a distinct possibility.

All in all, the steady growth in the number of statutory provisions favorable to close corporations and the prospect of additional and perhaps more rapid developments in the future demonstrate that the labors of the pioneer writers, who pleaded so eloquently for legislative recognition of the distinctive needs of close corporations, have not been entirely in vain.

[87] Senate Committee on Finance, *Internal Revenue Code of 1954*, S. REP. No. 1622, 83d Cong., 2d Sess. 118-19, 452-58 (1954). See also Haddad, *Organization and Operation of Corporations*, 43 ILL. B.J. 547 (1955).

[88] Conference Committee, *Internal Revenue Code of 1954*, H.R. REP. No. 2543, 83d Cong., 2d Sess. 72 (1954).

[89] Incidentally, there are many signs of an increased judicial recognition of the special problems of close corporations. For judicial developments, see Scott, *Developments in Corporate Laws*, 12 BUSINESS LAWYER 438, 439-46 (1957).

SOME MISCELLANEOUS NOVELTIES IN THE NEW CORPORATION STATUTES

Elvin R. Latty*

Introduction

The recent wave of revisions of the general business corporation statutes of many jurisdictions has typically introduced many changes that, while novel, perhaps, in their own particular contexts, are not at all revolutionary in American legislative history. Although examples abound, an apposite illustration are the newly-popular provisions relating to the maintenance and inspection of records:[1] there is practically nothing here that cannot be found somewhere in the corporate legislation enacted in this country during the first third of the present century. This is not to say, of course, that the current statutory revisions have produced no innovations—for, indeed, they have. Most of the more significant of these have, in fact, been explored in some detail elsewhere in this symposium. Accordingly, it is to a collection and discussion—although by no means an exhaustive one[2]—of some odds and ends that remain that this article is devoted.

By "new" corporation statutes, reference is made to those enacted in the 1940's and 1950's. This may, perhaps, be a rather arbitrary criterion, but it would seem, at least partially, to be indicated by the post-World-War-II ferment in the area of corporate legislation; moreover, it fits the midcentury outlook of this symposium. It need hardly be noted, however, that the extensive revisions of corporation statutes in the early 1930's—to which may be added, for good measure, the Ohio and Delaware revisions of the late 1920's—also introduced many new features; and the famous New Jersey corporation statute of 1896, which to a legal historian at least is recent legislation and which, it may be hazarded, is the fountainhead of modern American corporation law, was daringly unique in a number of respects.

I

Organization and Related Early-Stage Matters

1. *Corporate name*

Perhaps the most significant novelty in organizational stage is the right given by the new statutes of Oregon, Texas, and Virginia, following the Model Business

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[1] *E.g.*, N.C. Gen. Stat. § 55-38 (Supp. 1955); N.D. Laws 1957, c. 102, § 47; Ore. Rev. Stat. § 57.246 (Supp. 1955); and Tex. Bus. Corp. Act art. 2.44 (1956).

[2] A significant, but unsuspected, innovation may sometimes be effected, intentionally or otherwise, by an apparently innocent and minor change in a statutory text that is superficially quite orthodox. An

Corporation Act, to a foreign corporation not doing business in the state to "register" its name and to renew this registration from year to year.[3] This enables the "fencing in" of a name, if it is still open, which makes it unavailable even to local enterprises, in the event that the registrant should, in the future, expand its activities into the state and wish to use the name. This feature was not adopted in the District of Columbia, North Carolina, North Dakota, and Wisconsin, however, even though recent statutory revisions in those jurisdictions otherwise closely followed the Model Act's provisions relating to corporate names. Of course, even in jurisdictions not following the Model Act in this respect, a foreign corporation can still "fence in" its name, if it is still open, by forming and maintaining therein a subsidiary corporation; but this procedure is more expensive and cumbersome. The ultimate issue, then, is whether "fencing in" should be made cheaper and easier.

A 1957 Pennsylvania enactment authorizes the use of an injunction to prevent a corporation from using a name which it has agreed to give up, or a name deceptively similar, under a written consent duly executed and filed.[4]

A few recent statutes also make it clear that the choice of an official corporate name does not prevent the adoption of an assumed name as well.[5] Thus, for example, a corporation with the legal name of Smith Motor Repairs Co., Inc., might quite properly wish and be permitted to do business under the name of West Side Garage.

2. *Single incorporator*

Wisconsin's 1951 statutory revision admits of a single incorporator, instead of requiring the customary three or more.[6] This is not an entirely new idea,[7] but it is so rare as to merit notice. A more general adoption of this provision, however, can perhaps be anticipated in view of the apprehension aroused in one state recently by a decision that questioned the validity of a one-man corporation under the usual statutory provision requiring three or more incorporators.[8]

3. *Simplified incorporation procedure—single registry and little else*

The Model Act would streamline the incorporation procedure by having only a single central filing in the office of the secretary of state, dispensing with such additional rituals, found until recently nearly everywhere, as recording in the

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example of this might be those recent dividend statutes that, at first glance, seem to afford adequate protection by the "stated capital" cushion, but which, on closer examination, apparently remove all restrictions on the payment of dividends. See *infra* 374-76.

[3] ORE. REV. STAT. §§ 57.055, 57.060 (Supp. 1955); TEX. BUS. CORP. ACT art. 2.07, 2.08 (1956); VA. CODE ANN. § 13.1-8 (Supp. 1956); *cf.* MODEL BUSINESS CORPORATION ACT § 8.

[4] PA. STAT. ANN. tit. 15, §§ 2852-202, 2852-1002 (Supp. 1957).

[5] ORE. REV. STAT. § 57.045 (Supp. 1955); TEX. BUS. CORP. ACT art. 2.05 (1956).

[6] WIS. STAT. § 180.44 (1955).

[7] This unusual feature has long existed in Iowa, see IOWA CODE §§ 673 *et seq.*, 702 (1850), and persists today. IOWA CODE § 491.2 (1954). The other state with this feature permits the single incorporator to be itself a corporation. MICH. COMP. LAWS §§ 450.2, 450.3 (1948).

[8] Park Terrace, Inc. v. Phoenix Indemnity Co., 241 N.C. 473, 85 S.E.2d 677 (1955), *on rehearing*, 243 N.C. 595, 91 S.E.2d 584 (1956).

central office, filing or recording in a local county seat, submission of papers to other officials for approval, publication in newspapers, opening of books for subscriptions, affidavits of payment of specified percentages of capital stock, and others.[9] Texas, North Dakota, and Oregon have recently followed the Model Act's streamlining, even as to the single, central filing[10]—Oregon, only after a change of heart in 1955.[11] Other states that have come under the general influence of the Model Act, however, such as North Carolina, Virginia, and Wisconsin, still require local recording, presumably reflecting the sentiment of the bar.[12] But it is doubtful whether the infrequent need for a quick inexpensive look at local records, as against getting information from the central office, warrants the additional burden of local recording or even of local duplicate filing.

4. *Pre-incorporation subscriptions and promotional activities*

Although legislation designed to afford a mechanism for creating irrevocable pre-incorporation subscriptions to stock, so as to avoid the pitfalls that legal theory had created for business-like firm commitments, is not novel,[13] the near unanimity with which corporate law revisions since World War II have adopted the idea is worthy of that designation.[14]

A 1951 Oklahoma statutory amendment makes a pre-incorporation subscription revocable if the articles of incorporation are amended by the incorporators without consent of the subscribers.[15] Apparently the privilege to revoke is absolute, regardless of the seriousness of the amendment, although perhaps a court may take it upon itself to draw distinctions between material and immaterial amendments.[16]

Several novelties relating to subscriptions are also observable in the North Carolina statutory revision of 1955. This legislation does not recognize as a defense to the enforcement of pre-incorporation subscriptions the failure to notify the subscribers of

[9] MODEL BUSINESS CORPORATION ACT § 49. Florida, however, perhaps in response to the spirit of the land boom of the 1920's and in reaction to its previous cumbersome requirements, has had a simple, central-filing procedure since 1925. For the rituals previously required in Florida, see FLA. REV. GEN. STAT. §§ 4051, 4052, 4054 (1920).

[10] TEX. BUS. CORP. ACT art. 3.03 (1956); N.D. Laws 1957, c. 102, § 50; ORE. REV. STAT. § 57-316 (Supp. 1955).

[11] *Cf.* ORE. REV. § 57-316, as enacted in Ore. Laws 1953, c. 549, § 49.

[12] N.C. GEN. STAT. §§ 55-4, 55-8 (Supp. 1955); VA. CODE ANN. § 13.1-51 (Supp. 1956); WIS. STAT. § 180-48 (1955).

[13] MODEL BUSINESS CORPORATION ACT OF 1928, § 6, 9 U.L.A. 132 (1957), provided for irrevocable subscriptions. Legislation pattern thereon still embodies the idea. See LA. REV. STAT. § 12:6 (1950); IDAHO CODE ANN. § 30-109 (1948); WASH. REV. CODE § 23.08.020 (Supp. 1952).

[14] But irrevocability in the Oklahoma statutory revision of 1947 exists only by implication. See OKLA. STAT. tit. 18, § 1.31 (1951). Moreover, the Florida statutory revision of 1953 is silent on this topic, as is that of Virginia of 1956. This last, however, has been explained on the ground that under existing judicial decisions, particularly Marcuse v. Broad Grace Arcade Corp., 164 Va. 553, 180 S.E. 327 (1935), subscriptions are revocable only upon unanimous consent of the shareholders and subscribers. See Gibson, *The Virginia Corporation Law of 1956*, 42 VA. L. REV. 445, 459 (1956). But one must view the Virginia law as not completely settled, since the *Marcuse* case involved an attempted cancellation of a subscription duly accepted by the newly-organized corporation and not a pre-incorporation withdrawal by a subscriber.

[15] OKLA. STAT. tit. 18, § 1.31(b) and (d) (1951).

[16] *Cf.* 4 WILLIAM M. FLETCHER, CYCLOPEDIA CORPORATIONS §§ 1433, 1765 (1931).

their right to participate in selecting the first board of directors or in otherwise perfecting the organization.[17] It was apparently believed that this defense is used primarily as a convenient excuse to renege on a subscription and that, in real cases of "failure of consideration," where the excluded subscribers had been misled to believe that they would participate in perfecting the organization, a court could still find the exclusion to be a defense. That same legislation also undertakes to regulate in the matter of certain "come on" clauses or representations in connection with subscriptions—*e.g.*, payment to be made out of earnings, subscriber to have "put" option, etc. These features give rise to no defense against the corporation in the enforcement of the subscription, but only to actions against the guilty participants.[18] Since, however, this provision was apparently inserted for the benefit of innocent interests in the corporation, the absence of such interests might bring about a different result. In addition, this legislation provides a rather unusual alternative remedy against the subscriber who is in default on payments: the corporation is given the choice of rescinding and keeping as liquidated damages up to ten per cent of the subscription price.[19] Finally, the troublesome common-law distinction between "subscription" and "contract to purchase"[20] is sought to be minimized in this legislation by giving the corporation in any event, upon default the rights of enforcement that are normally characteristic of "subscription."[21]

Promotional activities call to mind the embattled field of promoters' liability for secret profits and overvaluation of property or services received as payment for stock and the related struggles over watered-stock liability. Fortunately, the awkwardness of state law, largely uncodified, which has, perhaps, served only to educate counselors of well-advised promoters as to the finer points of liability avoidance, is less crucial since the Federal Securities Act of 1933.[22] In any event, a novel exception to the general legislative disposition to leave these matters to the somewhat chaotic common law, with its dubious distinctions and refinements, rendered even more confusing by the advent of the no par value share, is the recent North Carolina statute's endeavor to combine the principles of promoters' liability with those of stock-watering liability, through a new statutorily-defined concept of "watered shares."[23] The statute adopts the basic idea that when the recipient of shares gets more than that to which he was entitled, in light of both his contribution to the corporation and his relationship to the venture and to those in control, he must either make an additional contribution or surrender some of his shares, whichever be the more appropriate remedy. This approach purports to clarify a number of troublesome points: liability does not turn on whether the diluted outside shareholders

[17] N.C. GEN. STAT. § 55-43(f) (Supp. 1955). *Cf.* Windsor Hotel v. Schenk, 76 W.Va. 1, 84 S.E. 911 (1915) (absent statute in point).

[18] N.C. GEN. STAT. § 55-43(e) (Supp. 1955).

[19] *Id.* § 55-43(i).

[20] *Cf.* Stern v. Mayer, 166 Minn. 346, 207 N.W. 737 (1926); Annot. 46 A.L.R. 1172 (1926).

[21] N.C. GEN. STAT. § 55-43(a) and (h) (Supp. 1955).

[22] 48 STAT. 74, 15 U.S.C. § 77 (1952).

[23] N.C. GEN. STAT. § 55-53 (Supp. 1955).

bought their shares directly from the corporation or from the stage-planning promoters nor on whether they were already shareholders when the promoters got their shares or came in later as per the promoters' plan; and liability cannot be evaded by the no par value stock device nor, in all probability, by the issuance of preferred shares to outsiders and watered common shares to the promoters.

5. *Corporate purposes*

A novel and heartening note of realism is found in the Wisconsin statute, which, after setting forth the usual requirement that the charter is to state the purpose for which the corporation is organized, goes on to provide:[24]

> It shall be sufficient compliance with this paragraph to state, either alone or with other purposes, that the corporation may engage in any lawful activity within the purposes for which corporations may be organized under this chapter, and all such lawful activities shall by such statement be deemed within the purposes of the corporation, subject to expressed limitations, if any.

Complementing this is a provision, itself not entirely novel, that "it shall not be necessary to set forth in the articles of incorporation any of the corporate powers enumerated in this chapter,"[25] which, in turn, is supported by a very broad corporate powers section enumerating an exhaustive list of corporate powers.[26] Here is a realistic recognition of the fact that today we are ready for a short-charter "all-purpose" corporation—one in which the stockholder has no right to expect management to adhere to enumerated channels of economic activity, but, rather, may well expect management to pursue any line of activity that bids fair to earn an honest dollar. The ancient tradition of the corporate charter as a "grant," to be narrowly construed, with its concomitant doctrine of ultra vires, has merely resulted in gobbledegook[27] drafting of omnibus charters, with fantastic enumeration of purposes and powers, plus tongue-in-cheek clauses that all the powers are also meant to be pur-

[24] WIS. STAT. § 180.45(1)(c) (1955). [25] *Id.* § 180.45(2).

[26] *Id.* § 180.04.

[27] ELVIN R. LATTY, INTRODUCTION TO BUSINESS ASSOCIATIONS 11 (1951): "Thus . . . you will not find the lawyer drafting 'to own and operate a drugstore' but more likely something like this gobbledegook in the drafting of which the writer once participated:

" 'To manufacture, import, export, buy, sell, use, distribute, transport, store and otherwise deal in and use drugs, drug sundries, medicines, patent medicines, prescriptions, medical formulae, proprietary articles, chemicals, extracts, tinctures, pomades, ointments, liniments, physicians' and hospital supplies and equipment, surgical instruments and equipment, scientific apparatus, dental goods, rubber goods, toilet articles and preparations, perfumes, cosmetics, paints, chemicals, oils, dye stuffs, brushes, electric goods and supplies, music, musical supplies, cameras, photographers' equipment and supplies, optical supplies, stationery, postcards, books, newspapers, magazines, periodicals, cigars, cigarettes, tobacco, smokers' supplies, candy, confectionery, soda, carbonated and aerated waters, ice cream, soft drinks refreshments, pastry, foods and food products, jewelry, hardware, leather goods, clocks, watches, cutlery, art goods, dry goods, notions, novelties, small wares, and all articles and other merchandise of every kind, nature and description, and all cartons, containers, kegs, barrels, jars, bottles, boxes, tins, packages and other materials or substances used in the packing, wrapping, boxing, preserving or marketing thereof; to operate, maintain or conduct warehouses and retail or wholesale stores, shops and stands in the United States or elsewhere for the purpose of storing, selling or otherwise dealing in any of the articles and other merchandise hereinbefore mentioned.'

"A paragraph like the foregoing is frequently just the beginning of the purpose and objects clause."

poses, plus clauses to counteract interpretations of *eiusdem generis* and *exclusio alterius*. All this boiler plate is meant, or hoped, virtually to create an all-purpose corpoartion. The time, therefore, has come to acknowledge this and, at least when the parties so desire, permit the creation of an all-purpose corporation, with a short charter enumerating not what the corporation *is to do,* but what, if anything, it *is not to do.*[28]

Presumably, then, the charter of a Wisconsin corporation can now simply state: "The purpose of the corporation is to engage in any lawful activity within the purpose for which corporations may be organized under the Business Corporation Law." True, one will not know what a corporation's activities are by looking at its charter; but realistically, even today, if one wants to know what kind of business activities the corporation is pursuing, he must look beyond the charter. And there is nothing in the authorization of an all-purpose corporation which prevents or even renders more difficult the appropriate solution of the problem of the rights and remedies of investors who, by misrepresentation, are induced to invest their money for one business purpose and find it applied quite differently.

A recent California enactment gives a novel twist to the idea of the informative charter by requiring the charter to state the corporate purposes, "including a statement in a separate paragraph identifying the specific business in which the corporation proposes primarily initially to engage."[29] There seems, then, still to be some life in the quaint notion of an informative charter, even though it discloses to the early reader of the charter only what the corporation is *going to start out to do,* and, to the later reader, only what it *originally started out to do.*

Novel, in the sense that it sounds a new note in modern legislative drafting, although state corporation statutes and even state constitutions at the turn of the century revealed a similar spirit, is the Texas resort to the "purpose" provisions of the business corporation statute to strike at one aspect of business activity that is usually thought of as being in the antitrust area—*i.e.,* forbidding a corporation in one line of activity to engage in a specific allied line that would result in a stifling combination. The new Texas statute forbids a corporation to combine stock-raising with slaughtering or subsequent processing, or oil-producing with oil pipe-lining.[30]

II

CORPORATE POWERS AND RELATED MATTERS

1. *New enumerated powers*

Recent legislation shows a decided trend away from that distrust of corporate enterprise which manifested itself in extremely strict views of ultra vires and in

[28] Contrast the philosophy of the new Texas statute requiring that "the purposes shall be fully stated in the articles of incorporation." TEX. BUS. CORP. ACT art. 2.01-A (1956). With this encouragement, the Texas lawyer should scale new heights of exuberant drafting. But Texas has long had a *sui generis* attitude toward corporate powers and purposes. See the now-displaced Texas Corporation Law. TEX. REV. CIV. STAT. art. 1302 (1948).

[29] CAL. CORP. CODE § 301(b).

[30] TEX. BUS. CORP. ACT art. 2.01-B(3) (1956). The qualifications in the prohibition indicate, however, that the welfare of local oil interests were not overlooked.

doctrines that always created a doubt when a corporation contemplated the employment of new techniques in keeping with the advancing science (or is it an art?) of management. The result has been a constant lengthening of the list of enumerated powers granted to corporations in state statutes.

2. *Donations*

Although expresss authorizations of donations for charitable, religious, scientific, educational, or other beneficient purposes have occasionally appeared in corporation statutes for a long time,[31] it is worthy of note that every jurisdiction that has substantially revised its corporation statutes since World War II[32] has inserted a provision of this sort. All of them except Kentucky[33] expressly authorize "charitable" donations, and all but the District of Columbia specifically sanction "education" as an appropriate object of corporate largesse;[34] a majority, however, shy away from likewise voicing approbation of religious donations.[35] Similar donative authorization has also been reflected in the statutes of a number of states which have not, in general, substantially revised their corporation statutes.[36] Most of these statutory provisions, however, seem to leave an opening for a conservative court still to require a fairly direct benefit to the corporation;[37] one cannot count always on the liberality and breadth of vision revealed in *A. P. Smith Mfg. Co. v. Barlow*.[38]

3. *Wartime powers*

A noteworthy sidelight on our troublesome times is cast by the adoption in several jurisdictions of the Model Act provision conferring power on a corporation, whatever be its business, to transact any lawful business in time of war and in aid of the United States in prosecution of the war.[39] Until recent times, such a provision, although not unknown,[40] was very rare.

4. *Fringe benefits*

The new statutory revisions have also evinced an inclination expressly to authorize,

[31] See Bell, *Corporation Support of Education: Legal Basis*, 38 A.B.A.J. 119 (1952), for a list of jurisdictions.

[32] California, District of Columbia, Florida, Kentucky, Maryland, North Carolina, Ohio, North Dakota, Oklahoma, Oregon, Texas, Virginia, and Wisconsin.

[33] KY. REV. STAT. § 271-125 (1955).

[34] D.C. CODE ANN. § 29-904 (Supp. 1956).

[35] *E.g.* California, District of Columbia, Florida, North Dakota, Ohio, Oklahoma, Oregon, and Texas. MODEL BUSINESS CORPORATION ACT § 4(m), however, authorizes religious donations.

[36] See de Capriles & Garrett, *Legality of Corporate Support to Education: A Survey of Current Developments*, 38 A.B.A.J. 209 (1952). Not to be overlooked is the authors' point that there may be a constitutional problem with respect to corporations formed before the statute was amended to permit the donation in question. The authors' view that the problem is not serious, however, is sound.

[37] See, however, the Oklahoma statute which authorizes donations that will "benefit or contribute to the *corporate* or *public interest*." OKLA. STAT. tit. 18, § 9 (1951). (Emphasis added.)

[38] 13 N.J. 145, 98 A.2d 581 (1953).

[39] MODEL BUSINESS CORPORATION ACT § 4(n), followed by D.C. CODE ANN. § 29-904 (Supp. 1955); N.D. Laws 1957, c. 102, § 4-13; ORE. REV. STAT. § 57.030(14) (Supp. 1955); TEX. BUS. CORP. ACT, art. 2.02(15) (1956); WIS. STAT. § 180.04(13) (1955).

[40] Apparently the idea grew out of World War I experience, as shown by a similar provision in the Illinois General Corporation Act of 1919, Ill. Laws 1919, at 318.

probably out of excess of caution,[41] the power to pay pensions and to establish plans for pensions, profit-sharing, stock bonuses, and other incentives for directors, officers, and employees—particularly in those jurisdictions that have closely followed the 1953 draft of the Model Act.[42] Again, there is no complete novelty here: a Pennsylvania statutory provision authorizing corporate pensions[43] dates apparently from 1893, at least in so far as it relates to "employees"; and the New Jersey statutory provision authorizing employee stock-acquisition plans and profit-sharing,[44] dating from 1920, is called to mind by the famous American Tobacco Co. litigation.[45]

5. *Partnership arrangements*

The new North Carolina statute permits corporations virtually to enter into partnership arrangements, even if that involves sharing control with others or delegating control to others.[46] The novelty of this provision lies largely in its specific attention to the troublesome corporate-partnership problem. Possibly the provision long existing in some state statutes which has permitted a corporation to acquire shares and "interests in" partnerships and other forms of enterprise could be stretched to reach the same end.[47]

6. *Guaranties*

The power conferred by one recent statutory revision in somewhat unusual phraseology, "to enter into contracts of guaranty or suretyship or make other financial arrangement for the benefit of its personnel or customers or suppliers,"[48] apparently is based on the fear that, in the light of the decisions of that state at least, mere general guaranty-authorizing language is not satisfactory.[49]

III

SOME MINUTIAE ABOUT DIRECTORS AND MANAGEMENT[50]

1. *Service on nonresident directors*

Beginning with Indiana in 1945,[51] several jurisdictions have subjected nonresident directors of domestic corporations to the process of local courts in suits by or against

[41] See Bleicken, *Corporate Contributions to Charities: The Modern Rule*, 38 A.B.A.J. 999, 1001 (1952).

[42] N.D. Laws 1957, c. 102, § 4-16; ORE. REV. STAT. § 57.030(16) (Supp. 1955); TEX. BUS. CORP. ACT art. 2.02(17) (1956); VA. CODE ANN. § 13.1-3(o) (Supp. 1956); *cf.* MODEL BUSINESS CORPORATION ACT § 4(p).

[43] PA. STAT. tit. 15, § 2852-316 (1936).

[44] N.J. REV. STAT. § 14:9-1 (1937).

[45] Rogers v. Guaranty Trust Co., 288 U.S. 123 (1933).

[46] N.C. GEN. STAT. § 55-17 (Supp. 1955).

[47] See CHICAGO BAR ASS'N, ILLINOIS BUSINESS CORPORATION ACT ANNOTATED 36 (2d ed. 1947), commenting on section 5(g) of that Act, which goes back to the 1933 revision.

[48] N.C. GEN. STAT. § 55-17(b)(3) (Supp. 1955).

[49] Very few corporation statutes specifically mention the power to guarantee, and the few that do seem to be aimed at guaranteeing securities of other corporations and enterprises. Fortunately, in many jurisdictions, a sound body of common law is fully adequate to business needs.

[50] The major trends and developments relating to directors and management are to be found in other articles in this symposium.

[51] IND. ANN. STAT. § 2-804b (1946).

the corporation to which the director is a "proper" or "necessary" party[52] or "relating to"[53] or "arising out of or founded upon" the action of a domestic corporation, with provision for substituted service upon the secretary of state or the corporation's service-of-process agent.[54] Such statutory provisions insure that at least one jurisdiction can entertain a derivative suit against directors in that awkward situation where the corporation, although a necessary party defendant, cannot be "found" in the same jurisdiction where the real defendants are.[55] A statutory provision of this kind, which has been held not to violate due process,[56] would also be helpful in meeting the difficulty presented by those decisions holding that in a suit to compel payment of dividends, the directors are necessary parties.[57] On compelling dividends, incidentally, the new North Carolina statute doubly clinches the matter by permitting a suit for that purpose to be brought against the corporation, with or without joining the directors.[58] A somewhat similar problem arose a few years ago when a suit to compel a corporation to cancel options allegedly given without consideration was dismissed because of failure to join the optionees, who were held to be necessary parties defendants;[59] but a recent statutory provision in one state at least would handle the problem by making the suit quasi in rem, with the "situs" of the option at the corporation's registered office, with the alternative of joining the optionees in an action in personam.[60]

2. *Directors-by-proxy*

A 1955 Arkansas enactment[61] permitting a director, if the bylaws so authorize, to vote by proxy, with the limitation that no director can be proxy-holder for more than one other director, is unique enough to warrant notice, although the idea is

[52] N.C. GEN. STAT. § 55-33 (Supp. 1955).

[53] S.C. CODE § 10-432.1 (1952).

[54] MICH. COMP. LAWS § 450.701 (Supp. 1956).

[55] A partial solution of the difficulty can sometimes be achieved in federal courts through a combination of diversity citizenship, the venue statute which permits a derivative suit to be brought in any judicial district where the corporations could have sued the directors, 62 STAT. 936 (1948), 28 U.S.C. § 1401 (1952), and the extraterritorial-service-of-process statute permitting process to be served on the corporation in any district where it is organized or licensed to do business or is doing business. 62 STAT. 945 (1948), 28 U.S.C. § 1695 (1952). But the diversity requirement itself can cause jurisdictional trouble for the plaintiff, although this has been somewhat alleviated by the recent case of Smith v. Sperling, 354 U.S. 91 (1957).

[56] Wagenberg v. Charleston Wood Products, Inc., 122 F. Supp. 745 (E.D. S.C. 1954).

[57] See Schuckman v. Rubenstein, 164 F.2d 952 (6th Cir. 1947) (applying Ohio law); Southern Mills v. Armstrong, 223 N.C. 495, 27 S.E.2d 281 (1943). See 15 A.L.R.2d 1124 (1954) for other decisions pro and con.

[58] N.C. GEN. STAT. § 55-50(k) (Supp. 1955).

[59] Elster v. American Airlines, Inc., 106 A.2d 202 (Del. Ch. 1954) (plaintiff was given an opportunity to bring in optional defendants, if he could serve them).

[60] N.C. GEN. STAT. §§ 55-45(d) (Supp. 1955).

[61] ARK. STAT. ANN. § 64-406 (Supp. 1957). This act purports to express the need for such a statute: "Inasmuch as it appears that many small domestic corporations may be severely handicapped in their operations by the inability of directors to attend meetings of the board because of illness or absence. . . ." Ark. Acts 1955, No. 83.

not entirely without statutory precedent.[62] Unlike stockholders, who are by statute everywhere permitted to vote by proxy, whatever be the common-law rule, orthodox doctrine requires directors to participate in meetings in person.[63] Even aside from the fact that directors are a representative body, their number and geographical dispersal do not create the same pressing need for proxy voting as do the number and geographical dispersal of the shareholders.

3. *Directors' control of compensation*

Despite the prevalence of stock-option compensation and the many comments that can be found in its favor as a method of attracting executive talent and spurring it on to even greater managerial achievements, an undercurrent of hostility to the practice, probably based on a suspicion of "too much of a good thing," occasionally comes to the surface in judicial decisions. Particularly significant was a series of Delaware decisions in 1952,[64] which adopted as their method of assault the classical "no-consideration" device for undermining contracts. These decisions led to a 1953 Delaware statutory amendment that "in the absence of fraud in the transaction, the judgment of the directors as to the consideration for the issuance of such rights or options and the sufficiency thereof shall be conclusive."[65] Similar legislation has since been enacted in Montana, New York, Virginia, and Pennsylvania.[66] It remains to be seen, however, whether a court, while conceding the finality of the directors' good faith judgment "as to consideration or its sufficiency," will still take it upon itself to inquire into "the very existence of consideration"[67]—which may require a certain judicial nimbleness. Incidentally, recent statutory provisions dealing specifically with the granting of stock options to management and employees show divergent views as to the necessity of shareholders' vote—a divergency that perhaps, again, reflects some apprehension of the possibility of abuses in this method of compensation.[68]

Novel, less for dealing with directors' adverse interest[69] than for singling out *self-voted* compensation, are recent enactments in Wisconsin, Ohio, and Illinois which

[62] See LA. REV. STAT. tit. 12, § 35F (1950), going back to 1928, but which requires an authorizing charter clause.

[63] HENRY W. BALLENTINE, CORPORATIONS 131 (rev. ed. 1946).

[64] Kerbs v. California Eastern Airways, Inc., 33 Del. Ch. 69, 90 A.2d 652 (Sup. Ct. 1952); Gottlieb v. Heyden Chemical Corp., 33 Del. Ch. 82, 90 A.2d 660 (Sup. Ct. 1952). *Cf.* Kaufman v. Shoenberg, 33 Del. Ch. 211, 91 A.2d 786 (Ch. 1952).

[65] DEL. CODE ANN. tit. 8, § 157 (Supp. 1956).

[66] MONT. REV. CODES ANN. § 15-1801 (1955); N.Y. STOCK LAW § 69; VA. CODE ANN. § 13.1-17 (Supp. 1956); PA. STAT. ANN. tit. 15, § 2852-612 (Supp. 1957).

[67] See Framkel v. Donovan, 120 A.2d 311, 316 (Del. Ch. 1956). See also Elster v. American Airlines, Inc., 128 A.2d 801, 807 (Del. Ch. 1957): ". . . the critical question remains that of whether or not consideration for the options existed as of the time they were granted. . . ."

[68] *Compare* MODEL BUSINESS CORPORATION ACT § 18A; COLO. REV. STAT. ANN. § 31-2-18 (1953); N.C. GEN. STAT. § 55-45 (Supp. 1955); VA. CODE ANN. § 13.1-17 (Supp. 1956); *with* OHIO REV. CODE § 1701.17 (Page Supp. 1956) (amended in 1955 to make it clear that shareholder's vote is not necessary); PA. STAT. ANN. tit. 15, § 2852-612 (Supp. 1957) (amended in 1957 to eliminate stockholder's vote requirement).

[69] The California corporation statute of 1931 led the way in this area. See CAL. CORP. CODE § 820, which has been little changed since 1931.

eliminate adverse interest as a technical defect and, presumably, will force attention to be focused on the really crucial matter—viz., the reasonableness of the compensation.[70] The new North Carolina statute sets as a standard of reasonableness for self-voted salaries "what would be paid for such services at arm's length under competitive conditions."[71]

A Wisconsin statutory provision is directed to a problem particularly contemporary in view of fringe-benefit practices and inflation: Must new plans look only to the future? What about present pensionees caught by inflation? The Wisconsin statute authorizes directors to pay pensions and other benefits to directors, officers, and employees and to their estates, families, dependents, or beneficiaries on account of or for prior services rendered.[72] To the extent that the power is used to readjust pensions and similar payments to reflect changing price levels or to avoid arguments of invalidity of newly-adopted pension plans based in part on prior service of existing employees, the provision should find clear sailing ahead. One may speculate, however, as to the ingenuity that the Wisconsin courts will display should overreaching arouse their hostility to the payments.

4. *Directors' power to mortgage and sell*

Particularly in view of statutes requiring a shareholders' vote for the sale of all of a corporation's assets, there is always the danger that a court will announce that a general mortgage of all of its assets, being a *potential* disposition in any event and perhaps a *present* transfer under the "title" theory of mortgages, requires a shareholders' vote.[73] Yet, the giving of security is a normal incident of borrowing, which traditionally is within the managerial sphere of directors. A few recent statutes, therefore, have settled the matter by specifically giving the mortgaging power to directors, free of any necessity for a shareholders' vote, unless the charter or the by-laws adopted by the shareholders otherwise provide.[74] Likewise, a number of recent statutes, either by following the language of the Model Act—which, in turn, mirrors the Illinois Corporation Act of 1933—in making a distinction between sales of all assets in the regular course of business and those outside the regular course of business,[75] or by different language with the same end in view,[76] permit the directors to sell all corporate assets in certain designated situations where any good cause to be served by a shareholders' vote requirement would be more than counterbalanced by the trouble and risk involved.

[70] WIS. STAT. § 180.31 (1955) (aimed, no doubt, at Stoiber v. Miller Brewing Co., 257 Wis. 13, 42 N.W.2d 144 (1950)); OHIO REV. CODE ANN. § 1701.60 (Page Supp. 1956); ILL. REV. STAT. c. 32, § 157.33 (1955), as amended, Ill. Laws 1957, S.B. 266.

[71] N.C. GEN. STAT. § 55-30 (Supp. 1955).

[72] WIS. STAT. § 180.31 (1955).

[73] See Greene v. Reconstruction Finance Corp., 24 F. Supp. 181 (D. Mass. 1938).

[74] N.C. GEN. STAT. § 55-112 (Supp. 1955); TEX. BUS. CORP. ACT art. 5.09 (1956), as amended, Tex. Laws 1957, S.B. 129; VA. CODE ANN. § 13.1-77 (Supp. 1956).

[75] This would include nearly all of the recently-enacted corporation statutes. *Cf.* MODEL BUSINESS CORPORATION ACT § 73.

[76] N.C. GEN. STAT. § 55-112(b) (Supp. 1955).

IV

DISTRIBUTIONS TO SHAREHOLDERS

1. *Accounting concepts*

Any remarks about dividends and other corporate distributions inevitably run into accounting concepts, but since other articles in this symposium are specifically devoted to these matters, there is no occasion at this point to more than reaffirm that recent corporation statute revisions, taking their cue largely from the Model Act,[77] have broken some new ground in clarifying the significance and incidents of earned surplus, revaluation surplus, other capital surplus, treasury shares, reserves, and, occasionally, reorganization surplus and subsidiaries' stock dividends.[78] Although the new corporation statutes are constantly pushing into new accounting areas, much of the pioneering along this line probably must be ascribed to the Ohio statutory revision of the late 1920's.[79]

2. *Free-wheeling dividends*

The significant novelties in corporate legislation are sometimes so concealed that only the most painstaking analysis will reveal them. An outstanding example of this is one phase of the dividend provisions[80] of the Model Act and of the statutes of the jurisdictions following that Act.

A quick reading of the Model Act would lead one to think: "I see that by section forty cash dividends can, in general,[81] be paid only out of earned surplus; well, that's a sound, conservative position; true, I see something in the next section about 'distributions in partial liquidation,' but that's another matter."

A second look at Model Act sections forty and forty-one would reveal that arrearages on cumulative preferred stock can be paid out of unearned surplus, which, too, is quite justifiable. But it would disclose that dividends, in general, can also be paid out of unearned surplus—only, they must be called "distributions in partial liquidation," and certain safeguards must be observed. Thus, dividends cannot be paid if the corporation is insolvent or if this would put the preferred shares under water, liquidation-wise; the recipients must be told that it is a distribution in partial liquidation; and unless the charter dispenses with the requirement, the distribution must be authorized by a two-thirds stockholders' vote. So far so good. Realistically, it *is* a partial liquidation when dividends are paid to shareholders out of anything but profits, current or accumulated. So far, nothing particularly revolutionary is involved—and it is a definite improvement over the laws of most jurisdictions.

But a closer reading reveals the novelty—and the joker. "The board of directors of a corporation may, from time to time, distribute to its shareholders in partial

[77] See, *e.g.*, WIS. STAT. §§ 180.02, 180.38, 180.385, 180.61 (1955).

[78] See N.C. GEN. STAT. § 55-49(k)(1) (Supp. 1955).

[79] 112 Ohio Laws 25 (1927), as amended, 113 Ohio Laws 433 (1929).

[80] The basic provisions are MODEL BUSINESS CORPORATION ACT §§ 40, 41; relevant also are *id.* §§ 5, 2, 63, 64.

[81] For the point under discussion, the "wasting asset" and other exceptions are immaterial.

liquidation, *out of stated capital* or capital surplus of the corporation, a portion of its assets, in cash or property. . . ."[82] Combine that with an "appropriate" charter clause, in reality written by management, dispensing with the necessity of a stockholders' vote to authorize the distribution,[83] and the result is this: If management wants it this way, dividends can be paid out of capital, if they are labeled distributions in partial liquidation, even if the corporation is losing money, unless it is facing creditor-insolvency or what may be called senior-shares-insolvency.[84]

In short, this permission of free-wheeling dividends does away with that venerable cornerstone safeguard in corporate law: legal capital, however phrased—*e.g.*, "stated capital," "capital stock," etc. This is the farthest north ever reached, anywhere in the world, it would seem, in a legal system for business units of limited liability. One may grant that the evolution of American law has been in that direction, considering both the frequently-permitted payments of dividends out of any surplus, including surplus arising from reduction of legal capital and the generally prevailing permission to reduce capital by mere stockholders' action, without veto rights of creditors—unless the creditors contract for it—and without necessity of judicial sanction, as required in England. Still, at least lip-service has always been paid to the capital concept as a cushion of sorts—reflecting, perhaps, some guilt feeling on the part of the statutory draftsmen in the various jurisdictions who carved out the capital-reduction loophole. This has been true even in those jurisdictions permitting "nimble dividends"—dividends out of current earnings, despite impairment of capital—since such disbursements are most likely made in periods of good health and in at least some jurisdictions must be accompanied by additional safeguards.[85]

The Model Act might well have addressed the matter more directly and have stated as follows: "Subject to such restrictions as may be stated in the charter, dividends can be paid irrespective of existence of profits or surplus or capital impairment, unless the payment would make the corporation insolvent in the equity sense or reduce its net assets below the liquidation priority of any class of shares senior to the recipients, but shareholders must be so informed when receiving dividends from sources other than earned surplus."

Recent statutory revisions in North Dakota, Oregon, and Wisconsin have fol-

[82] MODEL BUSINESS CORPORATION ACT § 41. (Emphasis added.)

[83] See *id.* § 41(b): "No such distribution shall be made unless the articles of incorporation so provide or such distribution is authorized by the affirmative vote of the holders of at least two-thirds of the outstanding shares of each class whether or not entitled to vote thereon by the provisions of incorporation of the corporation."

[84] Incidentally, diverse tests are adopted in the Model Act for creditor insolvency and for senior-shares-insolvency. For the former, the test of insolvency is merely the equity test, or inability to pay debts as they become due in the usual course of business. MODEL BUSINESS CORPORATION ACT § 2(n). For the latter, the test is whether the company's net assets (assets over debts) would fall below the preferred stock's priority in voluntary liquidation. *Id.* § 41(d). Since senior shares are not likely to "become due," the equity test is not feasible with respect to them, and the balance-sheet test is the only alternative. But that is no reason for not employing the balance-sheet test as an additional safeguard for creditors against free-wheeling dividends unrestricted by "capital" concepts. *Cf.* N.C. GEN. STAT. § 55-50(d)(2) (Supp. 1955); MD. ANN. CODE art. 23, § 33(d)(2) (1951).

[85] *E.g.*, N.C. GEN. STAT. § 55-50(c)(1)(2) (Supp. 1955); OKLA. STAT. tit. 18 § 132(a)(3) (1951).

lowed the Model Act in the free-wheeling pattern for dividend distribution,[86] but the District of Columbia, Texas, and Virginia, generally close followers of the Model Act in their revisions, have refused to leave this opening. Indeed, the new Texas statute shows a commendable concern for the reduction-surplus loophole, specifying that dividends from such a surplus, unlike dividends from any other lawful sources, must be authorized by a two-thirds vote of all classes of shareholders, even by ordinarily nonvoting classes.[87] This can afford additional protection to senior shares, although per se it does not afford much creditor protection. But the new statute then goes on to provide that if the corporation becomes insolvent, the directors voting for such dividends, or for stock repurchases from this source, will be liable to the corporation for the disbursements for the purpose of discharging "creditor claims which existed at the time such payments were made or which were incurred within thirty (30) days after notice of the reduction of stated capital had been filed," to the extent that such claims have not been fully paid after sharing in the corporate assets.[88]

3. *Barring old dividend claims*

Even after time-consuming research, it will not often be easy in any particular jurisdiction to determine whether the statute of limitations has run against declared but unpaid dividends.[89] Does the statute start running when the dividend becomes payable, or only upon demand and refusal? Is the answer to be reached by sheer logical deduction from the rule (or fiction?) that declaration of the dividend creates a debtor-creditor relation? Or is it a "trust" relation? Which statute applies—that relating to trusts, implied contracts, obligations in writing for the payment of money, or some other?[90] A recent Wisconsin statutory provision attempts to cope with the problem by cutting off the shareholder's rights to declared dividends and other distributions if the amount declared as a dividend or authorized in some other distribution remains unclaimed for six years from the date specified for payment.[91] This is to be done "upon declaration of forfeiture made by resolution of the board of directors," provided that six months' notice be given prior to the effective date of the forfeiture in substantially the same manner as prescribed for giving notice of shareholders' meetings—*i.e.*, mailed to shareholder at his address as it appears on the corporate records.[92] A recent Ohio statutory provision is somewhat similar, but it makes the lapse of time per se bar the claim, without the need of a forfeiture declaration by the directors.[93] A different legislative solution has been reached in some other jurisdictions by making dividends unclaimed after a prescribed period payable

[86] N.D. Laws 1957, c. 102, § 41; ORE. REV. STAT. § 55-221 (Supp. 1955); WIS. STAT. § 180.39 (1955).

[87] TEX. BUS. CORP. ACT art. 2.40-A(3) (1956).

[88] *Id.*, art. 2.41-A(6).

[89] See Note, *The Lost Shareholder*, 62 HARV. L. REV. 295 (1948).

[90] See generally *id.*; 11 FLETCHER, *op. cit. supra* note 16, § 5370 (1932).

[91] WIS. STAT. § 180.395 (1955).

[92] *Id.* § 180.24.

[93] OHIO. REV. CODE ANN. § 1701.34 (Page Supp. 1956).

to the state, there subject to either the claims of the owner if he shows up[94]—which at least relieves the corporation of liability to shareholders, although it does not get to keep the dividend—or escheat.[95]

4. *Strengthening or clarifying the insolvency limitation on dividends*

In an effort to do something about the gradual decay of legal capital as at least a modicum of protection for creditors, a phenomenon already mentioned, Oklahoma's new statute forbids dividends "when, after payment of such dividend, the net assets of the corporation shall not equal an amount in excess of one-fourth (¼) its debts and liabilities."[96] Although this is not entirely a new idea,[97] so rare is an attempt in that direction nowadays that the effort perhaps merits classification as a novelty.

Several jurisdictions have, for several decades, required that the corporation meet both tests of insolvency—the so-called bankruptcy and equity tests—before paying dividends.[98] That still leaves some question as to the basis of valuation for the bankruptcy test. One recent statute prescribes the test of "fair present value" of the assets,[99] apparently in the belief that at least this much protection for creditors is justified, even though this may impose a conservative dividend policy on the directors of a debt-loaded corporation.

5. *Charter clauses cutting down preferred stock's dividend sources*

One recent North Carolina dividend novelty is to forbid charter clauses that cut down the sources of dividends otherwise lawfully available for preferred stock.[100] Its purpose is to prevent the coercion of the preferred shareholders into a disadvantageous recapitalization bargain by persuading them that the payment of dividends to them is legally impossible, despite current earnings, unless they concur in a plan which embodies a capital reduction wiping out the capital impairment that under the charter provisions is preventing the payment of dividends.[101] It is always a hard policy choice legislatively to restrict freedom of contract, but it must be recognized that the charter, especially in publicly-held corporations,[102] is hardly a bargained contract.

6. *Protection of noncumulative dividends*

Another recent North Carolina novelty is the attempt to protect that "waif of the stock exchanges," noncumulative preferred stock, against dividend shenanigans by

[94] *E.g.*, N.C. GEN. STAT. § 116-22 (1952).

[95] *E.g.*, MICH. COMP. LAWS §§ 567.15, 567.22 (1948).

[96] OKLA. STAT. tit. 18, § 133(3) (1951).

[97] See CAL. CORP. CODE § 1908, which is aimed at the dissipation of capital by disbursements following its reduction. See also the required assets-liabilities ratio in the North Carolina corporation statute before July 1, 1957. N.C. GEN. STAT. § 55-116 (1950).

[98] *E.g.*, CAL. CORP. CODE § 1501; ILL. REV. STAT. § 157.41 (1955). These statutes go back to the early 1930's.

[99] N.C. GEN. STAT. § 55-50(c) (Supp. 1955). [100] *Id.* § 55-50(b).

[101] See Barrett v. Denver Tramways Corp., 53 F. Supp. 198 (D. Del. 1943), *aff'd*, 146 F.2d 701 (3d Cir. 1944).

[102] For legislative recognition of the wider role of contract in close corporations, see N.C. GEN. STAT. § 73(b) (Supp. 1955).

recognizing in its favor a "dividend credit," as defined[103] in the new statute. Briefly, a "dividend credit" arises in favor of noncumulative preferred shares for those years when less dividends were paid to those shares than could have been paid to them out of earnings; and so long as such dividend credit exists, no dividend is to be paid to junior shares.[104] In a sense, then, even noncumulative preferred is made cumulative-if-earned, charter provisions notwithstanding. Arguably, why be concerned about noncumulative preferred stock? It is never issued—at least as far as the writer has been able to ascertain—except in reorganizations, as a result of the bargaining and evaluating that takes place in that process. If plain noncumulative stock is what the interested parties have bargained for, why give them cumulative-if-earned stock? The answer is that no one in his right mind consciously bargains for directors'-whim-noncumulative stock—which is what out-and-out noncumulative preferred stock boils down to, short of "fraud" (whatever that is), and if an enterprise is so shaky that on reorganization it cannot issue an honest preferred stock, let it reorganize with plain common stock.

7. *Compulsory dividends*

Also novel is the new North Carolina statute's mildly-compulsory dividend provision,[105] although it has some claim of legitimate parentage in prior legislation in that state and elsewhere.[106] In substance, it requires a corporation, on written demand of twenty per cent of the stockholders, or of a class of stockholders in some situations, to pay out one-third of its annual net profits in dividends. Its purpose is to make it harder for the dominant majority in a close corporation successfully to work the traditional squeeze play, wherein one of the squeezors' strategems is to pay no dividends, despite good earnings, year after year, during which time the squeezors are getting their returns through self-voted salaries, until finally the exhausted squeezee sells out in desperation at a price satisfactory to the squeezors. The enactment under discussion is quite complex and technical, probably creating as many new problems as it solves and reflecting difficult policy choices. Obviously, the twenty-per cent-shareholder requirement renders the statute virtually inapplicable to publicly-held corporations, but the squeeze play is not much of a problem in those corporations.

8. *Repurchase of shares*

The "enabling" spirit of twentieth-century corporation statutes is well illustrated in the evolution of permission to a corporation to purchase its own shares. Its course can be seen in the swing from prohibition of purchase under an ultra vires analysis—in some jurisdictions at least, following the English precedent—to permissive pur-

[103] *Id.* § 55-(2)(5).

[104] *Id.* § 55-40(c).

[105] *Id.* § 55-50(c).

[106] The former North Carolina corporation statute had provided that the directors must, by January 31 if no other date is fixed, declare a dividend of all the accumulated profits over and above what is reserved for working capital. N.C. GEN. STAT. § 55-115 (1950). New Mexico has a similar dividend provision. N.M. STAT. ANN. § 51-3-16 (1953). Both of these provisions were patterned after one that appeared in New Jersey's famous corporation law of 1896, but which was subsequently eliminated.

chase from surplus, and thence to purchase even out of capital in a few favored situations where apparently there were deemed to be overriding considerations of corporate convenience. Ohio led the way in its corporation statutes revision of the 1920's, permitting purchases regardless of surplus in order to redeem redeemable shares, compromise claims, perform repurchase obligation to employees, resell to employees, eliminate fractional shares, resell to others shares repurchased under contract with shareholders, and buy out dissenters entitled to being bought out.[107] Recent legislative activity has added purchases under a contract with a shareholder to buy his share at his death,[108] purchases by open-end investment companies (variously phrased),[109] and purchases in partial liquidation of the corporation.[110] Increasingly, then, the creditor's cushion afforded by legal "capital" is being discarded as a mechanism for creditor protection.[111]

Some recent cross-currents against the stream of pure "enablingism" are, however, discernible. In North Carolina and Wisconsin, the repurchase of shares is forbidden if it would reduce the corporation's net assets below the liquidation priority of shares having preferential rights on liquidation over the class of shares purchased; and although it is not entirely clear, in Wisconsin even junior preferred shares may receive this protection on the purchase of senior preferred shares.[112] The District of Columbia's statutory revision,[113] in adopting a similar restriction on the redemption or purchase of *redeemable* shares, reveals ancestry in this respect in the California General Corporation Law of 1931, which shows that the basic idea is not a recent one. Subject to certain enumerated exceptions, North Carolina and Texas forbid the repurchase of junior shares when the corporation is in default in the payment of dividends on its senior shares.[114] The idea is sound; except for certain transactions where there is an overriding policy, as in the enumerated favored exceptions—*e.g.*, to pay dissenters, eliminate fractional shares, compromise claims, etc.—a corporation has no business using its funds to make this type of return of corporate assets to junior stockholders when there are arrearages on its preferred shares. North Carolina carries the idea one step further: even redeemable preferred shares are not to be purchased otherwise than by *redemption*—or for such favored corporate purposes as have already been mentioned—if there are dividend arrearages on those preferred shares, unless the shareholders of that class or the market are seasonably informed of the corporation's intention to make such purchases.[115] The idea here

[107] 113 Ohio Laws 437 (1929).

[108] UTAH CODE ANN. § 16-2-16 (1953).

[109] TEX. BUS. CORP. ACT art. 2.03-G (1956); N.C. GEN. STAT. § 55-52(a)(5) (Supp. 1955); VA. CODE ANN. § 13.1-4 (Supp. 1956).

[110] N.H. REV. STAT. ANN. § 294:28 (1955).

[111] But see OHIO REV. CODE ANN. § 1701.35 (Page Supp. 1956), for a return to a capital-impairment prohibition—except that the "stated capital" thus safeguarded is that which remains after the reduction effectuated by the purchase, as to which see *id.* § 1701.31.

[112] N.C. GEN. STAT. § 55-52(e)(3) (Supp. 1955); WIS. STAT. § 180.385(1)(b) (1955).

[113] D.C. CODE ANN. § 29-904a (Supp. 1956).

[114] N.C. GEN. STAT. § 55-52(e)(4) (Supp. 1955); TEX. BUS. CORP. ACT art. 203-C (1956).

[115] N.C. GEN. STAT. § 55-52(f) (Supp. 1955).

is to discourage a corporate practice that is not unknown: depressing the price of the redeemable preferred stock by passing dividends and then buying up the stock at less than its redemption price.

Besides the equity-sense insolvency limitation that is placed on the repurchase of shares, even in the favored instances of permitted repurchase out of capital, several jurisdictions have recently adopted the additional bankruptcy test of insolvency as a further safeguard.[116]

A novel attempt to foreclose favoritism in the repurchase of a corporation's own shares is seen in the North Carolina statutory provision that, except with respect to transactions in the specially-favored categories of the kind already mentioned, shares must be purchased only pro rata, or on an organized stock exchange, or upon the approval of the holders of a majority of the shares exclusive of those held by the selling shareholder, or in connection with regulated stabilizing operations.[117] A Wisconsin statutory provision, too, represents a commendable effort to prescribe the freezing of earned surplus applied to the repurchase of shares and then to state the transactions which may thaw out the surplus so frozen.[118]

The recent statutory revisions have also shown a tendency to abandon some restrictions, such as a required charter clause or a shareholders' vote, if shares are to be repurchased out of other than earned surplus, but this is merely refining an idea that emerged in the revisions of the 1930's.

One still, however, observes no statutory provision aimed at curbing that questionable practice of the Great Depression: the corporation's purchase of its own shares to bolster a falling market in those shares, sometimes in an effort to bail out the management.

V

DIVERSE MATTERS ABOUT SHAREHOLDERS AND THEIR HOLDINGS

1. *Stock certificate recitals*

The laws of a number of jurisdictions have, for some time, required stock certificates to contain a statement of the rights of the different classes or series of shares, if the shares are divided into classes or series. The increasing complexity in the capital structure of many corporations has resulted in longer and longer statements, particularly with respect to convertible preferred stock and sinking-fund provisions. Since the size of stock certificates does not expand accordingly, being set partly by tradition and partly by the rules of the stock exchanges for listed shares —eight inches by twelve inches is the New York Stock Exchange standard—the result has been that the print is getting smaller and smaller. (Incidentally, what with margins, stock-transfer legend, and reserved space, the actual space for text on

[116] MD. ANN. CODE art. 23, § 28(c) (1951); N.C. GEN. STAT. § 55-52(e)(2) (Supp. 1955); TEX. BUS. CORP. ACT art. 203-F (1956). Each of these states employs the standard of "fair value" of the assets in applying this test.

[117] N.C. GEN. STAT. § 55-52(c) (Supp. 1955).

[118] WIS. STAT. § 180.385(1)(c) (1955).

the back of a stock certificate is not much over six inches by five inches.) Indeed, the print is microscopic on occasions. The writer recently saw one certificate with an estimated 17,000 words of stock-provision text on the reverse side. Some state statutes have, for some time, permitted a summary in lieu of the full text, but no lawyer is happy with a summary. Recent legislation has met the problem by permitting the stock certificate to state the designation of the various classes or series of shares and then to state that the corporation will furnish the shareholder, without charge, a full statement of the stock characteristics as set forth in the charter.[119]

2. *Stock certificates with old signatures or seals*

In active stocks, large numbers of certificates bearing the signatures of the present corporate officers will be delivered to the transfer agent, who may have a large portion of them on hand even after those corporate officers have ceased to be such. To avoid the expense of scrapping these certificates and the trouble of signing new ones, nearly all recent substantial revisions of corporation statutes have provided that certificates with old signatures can still be issued as if the officers had not ceased to be such.[120] A further Illinois refinement is aimed at avoiding a similar technical snag where the corporate seal has been affixed to stock certificates prepared for issuance, but has been changed before they are actually issued.[121]

3. *Cash for fractional shares*

An Ohio statutory provision has added to the choices available to a corporation faced with issuing fractional shares: as an alternative to issuing scrip in lieu of fractional shares, the corporation may pay off the fractional shares in cash.[122] Illinois followed suit in 1957.[123] It remains to be seen whether someone will attempt a minority freeze-out by a corporate recapitalization which, by decreasing the number of outstanding shares, reduces the minority freezee to ownership of less than one share, particularly under the Ohio statute where apparently the board of directors can fix the value of the fractional share.

4. *Registered shareholders with fiduciary or incomplete capacity*

The voting, transfer of shares and receipt of dividends by shareholders of record who are minors or holders in a fiduciary relation has long been a source of worry

[119] FLA. STAT. § 608.41 (1955); N.C. GEN. STAT. § 55-57 (Supp. 1955); N.D. Laws 1957, c. 102, § 20; OHIO REV. CODE ANN. § 1701.25 (Page Supp. 1956) (certificate may recite that a statement of the express terms of the shares is on file at an office of the corporation within the state or with a transfer agent); TEX. BUS. CORP. ACT art. 2-19 (1956), as amended, Tex. Laws 1957, c. 54 (mere reference to provisions filed with the secretary of state suffices); VA. CODE ANN. § 13.1-20 (Supp. 1956); WIS. STAT. § 180.18 (1955). MD. ANN. CODE art. 23, § 27(c) (1951) (summary of information included in a registration statement permitted to become effective under the Federal Securities Act of 1933 is acceptable).

[120] The recent statutory revisions in District of Columbia, Florida, Kentucky, Maryland (also former law), North Carolina, North Dakota, Ohio (also former law), Oklahoma, Oregon, Texas, Virginia, and Wisconsin embody this feature. Delaware, too, has had such a statute for some time.

[121] ILL. REV. STAT. c. 32, § 157.21 (1955), as amended, Ill. Laws 1957, S.B. 266.

[122] OHIO REV. CODE ANN. § 1701.24 (Page Supp. 1956).

[123] ILL. REV. STAT. c. 32, § 157.22 (1955), as amended, Ill. Laws 1957, S.B. 266.

to corporations, and scattered legislative recognition[124] of the problem antedates even the Uniform Fiduciaries Act, section three of which relieves the corporation of the duty to inquire into possible breaches of trust in the transfer of the shares by a shareholder of record who is a fiduciary.[125] Amendment to the corporation statutes of California and Ohio in 1931 already had extended protection to the corporation when stock transfer or voting was by a shareholder who was a minor; and the Ohio statute went further by giving the corporation the benefit of a conclusive presumption of full capacity of the registered shareholder, absent delivery to it of a certified copy of a court order of guardianship of the shareholder.[126]

Recent legislative activity along these lines has developed some refinements. A New York statutory provision authorizes a corporation to treat an infant shareholder as entitled to receive dividends and other distributions, vote, give consent, give proxies, make elections, and exercise rights relating to his stock, with no right in the infant to disaffirm as against the corporation; but this protection to the corporation is mitigated by the qualification: unless the corporation has actual knowledge of the infancy.[127] The recent North Carolina statute makes knowledge of minority or other incompetency or lack of authority of a representative irrelevant as far as the corporation is concerned,[128] although presumably the saving graces of equity would prevent the corporation from exploiting the incompetency to its unjust enrichment. So, whatever rights a minor who repudiates the cashing of his dividend check may have against other parties, the corporation is in the clear. A recent Ohio statutory amendment goes beyond merely immunizing the corporation by specifically empowering a minor to vote his shares.[129]

Although the purpose of section three of the Uniform Fiduciaries Act, which dates from 1922, was to relieve corporations of the risks inherent in transferring shares held by fiduciaries, the Act, since adopted in twenty-three states, has been aptly termed a conspicuous failure.[129a] In the 1940's and 50's, Connecticut, Oklahoma, and Virginia enacted statutory provisions to free corporations of the need to inquire into the authority of fiduciaries in making transfers of stock (or other securities);[129b] and the Uniform Commercial Code, recently adopted by Pennsylvania, Massachusetts, and Kentucky, would extend similar protection to corporations on security transfers other than those made by fiduciaries, particularly the revised versions of the Code enacted by Massachusetts and Kentucky.[129c] Also patterned on the Uniform Com-

[124] See MASS. GEN. ACTS 1918, c. 68, § 3.

[125] 9B U.L.A. 17 (1957).

[126] CAL. CORP. CODE § 2221; OHIO REV. CODE ANN. §§ 1701.28(D), 1701.46 (Page Supp. 1956).

[127] N.Y. GEN. CORP. LAW § 12-a. A 1953 Wisconsin statutory provision is substantially along these lines. WIS. STAT. §§ 180.85, 180.851 (1955).

[128] N.C. GEN. STAT. § 55-59 (Supp. 1955).

[129] OHIO REV. CODE ANN. § 1701.46 (Page Supp. 1956).

[129a] Conard, *A New Deal for Fiduciaries' Stock Transfers*, 56 MICH. L. REV. 843, 844 (1958). Professor Conard's fine study shows the inadequacy of this legislation in achieving its purpose.

[129b] CONN. GEN. STAT. § 2911d (Supp. 1955); OKLA. STAT. tit. 18, § 1.118 (1951); Va. Acts 1948, c. 162, repealed Va. Acts 1956, c. 428, § 1.

[129c] PA. STAT. ANN. tit. 12A, §§ 8-401-04 (1954); MASS. ANN. LAWS c. 106, §§ 8-401-04 (Supp. 1958); Ky. Acts 1958, c. 77, pp. 377-80.

mercial Code is a 1953 Wisconsin statutory provision.[129d] Moreover, three states have recently adopted the Model Fiduciaries Securities Transfer Act,[129e] a product of the joint efforts of committees of the American Bar Association and the Illinois State Bar Association, which purports to simplify transfers and minimize issuers' liability in connection therewith. For a discussion of the differences, effectiveness, and potentials of these various statutes, including the national and international conflict-of-laws angles, the reader is referred to Professor Conard's excellent analysis.[129f] Finally, although not generally thought of as in the field of corporation law, the "nominee statutes," permitting some kinds of trustees to put the entrusted securities in the name of a nominee, which burst forth largely in the 1940's and 50's would seem to achieve, despite their imperfections,[129g] some degree of simplification of security transfers and some relief from breach-of-trust liabilities of corporate issuers and their transfer agents.[129h]

5. *Notices to enemy shareholders*

The period under consideration produced some war-inspired corporate legislation,[130] including scattered statutory provisions relating to communications and notices to shareholders who are forbidden contacts, such as enemies or near-enemies. One problem to which these provisions were directed arises from the conflict between a statutory requirement of notice to shareholders and directors relating to meetings, and the Federal Trading With the Enemy Act proscribing such notice.[131] New Jersey and New York in 1942 and Delaware in 1943, accordingly, enacted legislation which provided that any notice otherwise required is dispensed with as to persons with whom communication is forbidden by any federal law, rule, regulations, or executive order.[132] Similar action has been taken, somewhat belatedly (one hopes) in Ohio and North Carolina.[133]

VI

STOCK TRANSFER RESTRICTIONS

The new Texas statute is the only legislation, recent or otherwise, that goes into any detail in the matter of stock transfer restrictions.[134] The real heart of the matter, however—viz., which restrictions are and which are not reasonable—was apparently believed to be too complicated for solution by detailed statutory rules.

[129d] WIS. STAT. § 180.85 (1955).

[129e] Conn. Pub. Acts 1957, No. 573; Del. Laws 1957, S.B. 287; ILL. REV. STAT. c. 32, §§ 439.50-57

[129f] Conard, *supra* note 129a. See also *id.*, *Simplification of Security Transfers by Fiduciaries*, 94 TRUST & ESTATES 835 (1955).

[129g] See Comment, 56 MICH. L. REV. 963 (1958).

[129h] Citations to the statutory provisions of the forty-two states having such legislation may be found in the appendix to *id.* at 985-1003.

[130] See, *e.g.*, *supra* 369 relating to wartime corporate powers.

[131] 40 STAT. 412 (1917), 50 App. U.S.C. § 3c (1952).

[132] DEL. CODE ANN. tit. 8, § 230 (1953); N.J. REV. STAT. § 1:1-2.5 (Supp. 1944); N.Y. GEN. CORP. LAW § 32.

[133] OHIO REV. CODE ANN. § 1701.43 (Page Supp. 1956); N.C. GEN. STAT. § 55-173 (Supp. 1955).

[134] TEX. BUS. CORP. ACT art. 2.22 (1956).

Accordingly, the express statutory authorization is stated in terms of restrictions that do not "unreasonably" restrain or prohibit transferability, or that "reasonably" define the rights of the corporation or of its shareholders to buy shares offered for transfer, or that "reasonably" define rights and obligations under buy-and-sell agreements binding on all shareholders of the class of shares in question, if the number of record shareholders of that class does not exceed twenty. The restrictions can be imposed in the bylaws as well as in the charter, thus clarifying at least one minor problem that has bothered some courts, and restrictions so imposed by the corporations must be stated on the stock certificates. (Query, does that invalidate a side agreement of the buy-sell variety, not stated in the certificates? Presumably not, as between the parties thereto; these are not restrictions *imposed* by the corporation. Anyhow, the statute in this respect differs little from section fifteen of the Uniform Stock Transfer Act.[135])

VII

PROXIES AND OTHER MATTERS RELATING TO VOTING

1. *Proxies*

One state has recently given legislative attention to the troublesome problem of irrevocable proxies instead of leaving the matter to that somewhat complex area of agency law that is unfortunately associated with the "coupled with an interest" doctrine. A 1953 New York enactment provides that an irrevocable proxy, if it is so labeled and if it expressly purports to be irrevocable, can be held by a pledgee, a purchaser under an executory contract to buy shares, a creditor to whom the proxy is given in consideration of credit extension, or a person who gets such a proxy as part of the consideration of his contract to perform services for the corporation as an officer.[136] (The irrevocability of proxies in that state is apparently limited to the situations above specified,[137] which may be unduly restrictive.) A purchaser of shares without actual notice of the irrevocable proxy thus authorized, however, takes free of it, unless the irrevocability is plainly stated on the face of the stock certificate. New York had already moved somewhat in the direction of legislative recognition of irrevocability of proxies, although not too clearly, in its 1929 enactment that "every proxy shall be revocable at the pleasure of the person executing it . . . but the parties to a valid pledge or to an executory contract of sale may agree in writing as to which of them shall vote the stock until the contract of pledge or sale is fully executed."[138]

The new North Carolina statute is unique in limiting the irrevocability of proxies to ten years, even if coupled with an interest.[139] Its purpose was apparently to harmonize the time limitation to that of voting trusts[140] and pooling agreements,[141]

[135] 6 U.L.A. 20 (1922).

[136] N.Y. STOCK CORP. LAW § 47-a.

[137] *Ibid.*

[138] N.Y. GEN. CORP. LAW § 19.

[139] N.C. GEN. STAT. § 55-68 (Supp. 1955).

[140] *Id.* § 55-72.

[141] *Id.* § 55-73(a).

the voting-trust statute in that state recognizing no exception to the ten-year limitation for the coupled-with-an-interest situation, unlike that of some other states. Apparently it was believed that ten years is long enough to tie up voting rights, especially in view of the fact that a party who needs a longer period may be in a position, under a sufficiently foresighted contract, to exert pressure upon the proxy-giver to execute additional irrevocable proxies from time to time as called for by the contract, thus extending the ten-year period.

2. *Voting trusts*

A new wrinkle in voting trusts has appeared in the Florida statutory provision that seems to abandon the theory that the voting trustees have legal title to the shares. It contemplates instead that the trustees "shall not acquire the legal title to the stock but shall be vested only with the legal right and title to the voting power which is incident to the ownership of the stock."[142] (A rather intriguing concept of "title.") The certificates for the shares concerned are to be tendered to the secretary of the corporation for him to note thereon the subjection of the shares to the voting agreement, which fact is to be "recorded" by him in designated corporate books, and this notation subjects purchasers of the shares to the voting trust. It appears that the intention here may have been to dispense with the common practice of registering the shares in the names of the voting trustees (the shareholder surrendering his old certificate and the trustees possessing the new one) and of the issuance by the latter of trustees' certificates; instead, the annotated stock certificates are apparently to be left in the hands of the beneficial shareholders. If the result is a "trustee" with neither legal title nor possession of the "res," this serves to remind us that it is sometimes easier to attain a specific result from a court or legislature under a reassuring false label than by sheer analytical honesty and plain talk. What this Florida statutory provision seems to come down to is that if you agree to let someone else vote your shares for ten years or less, he can do so, regardless of your change of heart. Compare the caution with which the New York statute approaches the problem semantically as one of "irrevocable proxies," limiting the irrevocability to designated situations.

A further novelty in voting trusts is found in the new North Carolina requirement that the real shareholders—the holders of the beneficial interests—are to retain their voting rights in such fundamental matters as charter amendment, bylaw amendment, capital reduction, merger, consolidation, sale of assets, and dissolution.[143] The theory apparently is that the main business need for a voting trust is to assure stability in management and that for this, little more is needed than to give the voting trustees the power over choice of management.

New York requires voting trustees to keep records of certificate holders comparable to the corporation's stock books and subject to analogous rights of inspection

[142] FLA. STAT. § 608.43 (1955). A later amendment eliminated an ambiguity in the new theory by eliminating a reference in the statute to stock "held" by the trustees; the shares are now referred to as the "stock as described in the agreement."

[143] N.C. GEN. STAT. § 55-72(c) (Supp. 1955).

by certificate holders.[144] The recent North Carolina statute has a similar requirement.[145]

3. *Self-voted shares*

The Model Act puts into specific statutory language a sound principle that courts probably recognize anyway[146]—viz., that shares in the parent corporation owned by a subsidiary corporation are not to be voted or counted for quorum purposes, any more than are treasury shares.[147] The recent statutory revisions in North Carolina, North Dakota, Oregon, Texas, and Virginia follow the Model Act in this respect.[148] The famous New Jersey statute of 1896, followed in this respect in a number of states, had already forbidden the voting "directly or indirectly" of shares of its own stock "belonging to" the corporation, language which lends itself to reaching the same result.[149] Recent legislation in the District of Columbia and Wisconsin adopts this older pattern.[150]

Legislative concern with a corporation's voting of shares of its own stock held in a fiduciary capacity is not new.[151] But the Model Act's policy choice of *not* permitting such shares to be voted is of recent vintage, at least in state law,[152] and represents a controversial choice, followed in some statutes subsequent to the Model Act,[153] rejected in others.[154]

4. *Pooling agreements*

Agreements for voting several blocs of shares of different shareholders as one unit have led a checkered life,[155] but no statute seems to have specifically concerned itself with the problem before the recent North Carolina statute.[156] This statute recognizes the validity of such agreements, if limited to ten years—to synchronize with similar limitations on the analogous voting trust—but does not contemplate that the stockholders' meeting is to be the forum for specific enforcement of the agreement.[157]

[144] N.Y. STOCK CORP. LAW § 50.

[145] N.C. GEN. STAT. § 55-72(b) (Supp. 1955).

[146] See Italo Petroleum Corp. v. Producers Oil Corp., 20 Del. Ch. 283, 174 Atl. 276 (Ch. 1934).

[147] MODEL BUSINESS CORPORATION ACT § 31.

[148] N.C. GEN. STAT. § 55-67(b) (Supp. 1955); N.D. Laws 1957, c. 102, § 30; ORE. REV. STAT. § 57.170 (Supp. 1955); TEX. BUS. CORP. ACT art. 2.29(B) (1956); VA. CODE ANN. § 13.1-32 (Supp. 1956).

[149] O'Connor v. International Silver Co., 68 N.J. Eq. 67, 59 Atl. 321 (Ch. 1904), *aff'd*, 68 N.J. Eq. 680, 62 Atl. 409 (Ct. Err. & App. 1905).

[150] D.C. CODE ANN. § 29-911(b) (Supp. 1956); WIS. STAT. § 180.25 (1955).

[151] See, *e.g.*, ILL. REV. STAT. c. 32, § 157.29 (1955); PA. STAT. tit. 15, § 2852-508 (1936).

[152] *Cf.* 48 STAT. 186 (1933), 12 U.S.C. § 61 (1952) (stock in national bank held by it as sole trustee).

[153] N.C. GEN. STAT. § 55.67(b) (Supp. 1955); N.D. Laws 1957, c. 102, § 30; ORE. REV. STAT. § 57.170 (Supp. 1955); TEX. BUS. CORP. ACT art. 2.29 (1956).

[154] D.C. CODE ANN. § 29-911(b) (Supp. 1956); WIS. STAT. § 180.25 (1955). For an intermediate position, see VA. CODE ANN. § 13.1-32 (Supp. 1956).

[155] *Compare* Ringling Bros.-Barnum & Bailey Combined Shows, Inc. v. Ringling, 29 Del. Ch. 610, 53 A.2d 441 (Sup. Ct. 1947), *with* Roberts v. Whitson, 188 S.W.2d 875 (Tex. Civ. App. 1945), and authorities therein cited.

[156] N.C. GEN. STAT. § 55-73(a) (Supp. 1955).

[157] *Cf.* Smith v. San Francisco & N. P. Ry. Co., 115 Cal. 584, 47 Pac. 582 (1897).

VIII

Fundamental Changes

Other articles in this symposium will generally discuss the current tendencies in the area of fundamental corporate changes. This discussion, accordingly, is purely supplemental.

1. *Protecting the high-vote protection*

With the virtual disappearance of "vested rights" and the almost limitless present-day scope of charter amendment, a shareholder holds that bundle of rights that we call his shares virtually at sufferance; votes of others may transform that bundle into one utterly, perhaps shockingly, different. The parties to the charter contract may, therefore, want to freeze the status quo in large measure by a clause to the effect that amendments can be made only by a prescribed vote, higher than otherwise required. Perhaps such a clause cannot itself be changed by a mere majority or two-thirds vote, if those are the statutory standards for charter amendments;[158] but to clinch the matter, two recent statutes specify that such a clause cannot itself be changed except by the same so-prescribed higher vote.[159] One of these statutes is also fortified by a similar provision with respect to changes effected by merger or consolidation,[160] just to forestall evasions by resort to the *Havender* subterfuge.[161]

2. *Reorganization and federal statutes*

During the 1930's, Delaware, Maine, Maryland, New Jersey, New York, and Pennsylvania adopted statutes to synchronize state law with reorganizations under the Federal Bankruptcy Act.[162] The scheme of these statutes was, in general, that pursuant to the provisions of a court-confirmed plan of reorganization, fundamental changes in the corporate structure and securities could be made, without the vote of shareholders and without dissenters' right of appraisal, by the registry of a prescribed certificate executed by court-designated representatives, such as trustees, corporate officials, and masters. The principal innovation introduced in later decades was the extension of this technique to include reorganizations pursuant to the Federal Public Utility Holding Company Act of 1935 in California, Delaware, Maine, Michigan, New Jersey, New York, Ohio, Oklahoma, and Virginia.[163] Wisconsin contents itself with requiring the secretary of state and the register of deeds to file and record duly certified court orders in proceedings under the Bankruptcy

[158] Sellers v. Joseph Bancroft & Sons Co., 23 Del. Ch. 13, 2 A.2d 108 (Ch. 1938).

[159] N.C. Gen. Stat. § 55-100(b)(3) (Supp. 1955); Va. Code Ann. § 13.1-56 (Supp. 1956).

[160] N.C. Gen. Stat. § 55-108(b) (Supp. 1955).

[161] Federal United Corp. v. Havender, 24 Del. Ch. 319, 11 A.2d 311 (Sup. Ct. 1940). By the "*Havender* subterfuge," the writer is referring to what is probably the cleverest corporation law trick of our times, whereby the law forbidding a given charter amendment can be avoided and/or evaded by a fake merger. *Cf.* Langfelder v. Universal Laboratories, Inc., 163 F.2d 804 (3d Cir. 1947).

[162] Del. Code Ann. tit. 8, § 245 (1953); Me. Rev. Stat. Ann. c. 53, § 77 (1954); Md. Ann. Code art. 23, § 71 (1951); N.J. Rev. Stat. § 14:14-44 (1937); N.Y. Gen. Corp. Law § 9-b; Pa. Stat. Ann. tit. 15, § 2852-320 (Supp. 1956).

[163] The various Delaware amendments probably served as the source. See note following Del. Code Ann. tit. 8, § 245 (1953).

Act that affect charter amendments, without prescribing the effect of the procedure.[164]

The Oklahoma statute raises an entirely different problem when it authorizes "compromise arrangements" between categories or classes of them, to become binding upon approval by prescribed percentages if sanctioned by the court.[165] One wonders whether a thus rearranged creditor might not still assert his old position on the ground that the Bankruptcy Act's reorganization provisions have superseded the state law.[166]

3. *Unfair fundamental changes in senior shares*

The picture here is the recapitalization plan which wipes out the many years of dividend arrearages on cumulative preferred stock, so that the wide gulf that prevents the common stock from participating in the corporation's sudden prosperity is eliminated. As Messrs. Stevens and Larson have well put it:[167]

> That the common stockholders should enthusiastically embrace the resulting recapitalization plans, with the elimination of accrued preferred dividends and usually the sacrifice of other preferential rights by the preferred is easily understandable; what may puzzle the reader of these cases is: why is there always to be found approval also by a majority of the preferred, and, more often than not, a very large majority?
>
> The answer seems to be that preferred stockholders . . . can usually be depended upon to approve anything that is submitted in a persuasive proxy letter.

Understandably, management likes the prevalent law on the point: short of "fraud," approval by a majority of the affected class makes any question about fairness irrelevant. Not much has been done about this in recent legislation, less because of a Candidian faith in this best of all possible rules than because of two factors: (1) it is not easy to legislate on this problem without running into practical difficulties; and (2) the constituency of most state corporation law revision committees is not inclined to advocate features disliked by management. An occasional effort, direct or indirect, has, however, appeared in recent legislation.

A 1951 Nebraska statutory provision authorizes an adversely affected shareholder to apply to a court to enjoin, on the grounds of "fraud or *unfairness,*" a charter amendment altering priorities of preferred shares.[168]

Recent North Carolina legislation has moved more cautiously, recognizing the difficulties facing a court passing on fairness, which often ultimately boils down to a forecast of future earnings,[169] particularly if under the plan, the preferred stock

[164] WIS. STAT. § 180.56 (1955).

[165] OKLA. STAT. tit. 18, § 170 (1951).

[166] *Compare* International Shoe Co. v. Pinkus, 278 U.S. 261 (1929), *with* Johnson v. Star, 287 U.S. 527 (1932).

[167] ROBERT S. STEVENS & ARTHUR LARSON, CASES AND MATERIALS ON THE LAW OF CORPORATIONS 637 (2d ed. 1955).

[168] NEB. REV. STAT. § 21-1162 (1954). (Emphasis added.)

[169] A recapitalization plan can, of course, be clearly unfair on its very face, as where, for example,

receives some common stock or becomes "participating" or convertible. The new North Carolina statute contains a provision forbidding clauses in the charter or elsewhere that would render current earnings unavailable for dividends to preferred shares.[170] This is accompanied by statutory authorization for payment of dividends out of current earnings despite capital impairment and does away with a club with which the common stock—through its spokesman, management—can bludgeon the preferred shareholders into voting for a dubious plan.[171]

The North Carolina legislation has, at the same time, also made it possible for the preferred shareholders to bargain at the charter stage for a contract changeable only by a bargained high vote, which conceivably could be set so high as to make changes virtually impossible.[172] It makes a novel effort, too, to put a floor under the dissenting preferred shareholders' payment—two-thirds of their liquidation priority if the common shareholders pay nothing for retaining their position in the recapitalized corporation.[173] Furthermore, it extends appraisal rights to objecting holders of preferred shares with arrearages when those arrearages are being adversely affected by a "voluntary" exchange of securities pursuant to a transaction that involves no charter amendment, merger, consolidation, or similar appraisal event.[174]

4. *Appraisal rights*

The new Virginia statute has a meritorious provision that dissenting shareholders with appraisal rights with respect to a fundamental change—under that statute, in merger, consolidation, or sale of assets—who are unable to agree with the corporation as to the value of their shares can be made parties, wherever residing, to a judicial proceeding to determine what is due them, "as an action against their shares quasi in rem."[175] This may be preferable to such procedural alternatives as joinder of the dissenters as parties plaintiff or defendant and consolidation of scattered suits.[176]

The whole question of dissenters' rights to appraisal and payment needs reexamination. Too often our statutes have withheld such rights where probably needed and have conferred them in situations where not needed—automatically, for example, in mergers, regardless of whether the merger means for the dissenter a substantially different enterprise. The pattern is haphazard. Often the existence of such rights turns on the form of a transaction, rather than on its substance. Why should a merger subject the expanding entity to appraisal rights by dissenters when a

whatever be the future earning prospects, it requires the preferred stock to make all of the sacrifice and the common stock to make none, or virtually none, although such a plan was involved (and judicially upheld!) in Donahue v. Heuser, 239 S.W.2d 238 (Ky. 1951).

[170] N.C. GEN. STAT. § 55-50(b) (Supp. 1955).

[171] See *supra* 377.

[172] N.C. GEN. STAT. § 55-100(b)(3) (Supp. 1955).

[173] N.C. GEN. STAT. § 55-113(e) (Supp. 1955). Otherwise, there is the danger illustrated by Root v. York Corp., 22 Del. Ch. 351, 50 A.2d 52 (Ch. 1946), in light of Hottenstein v. York Ice Machinery Corp., 136 F.2d 944 (3d Cir. 1943).

[174] N.C. GEN. STAT. § 55-102 (Supp. 1955).

[175] VA. CODE ANN. § 13.1-75, 13.1-78 (Supp. 1956).

[176] See OHIO REV. CODE ANN. § 1701.85 (Page Supp. 1956).

similar expansion by acquisition of properties financed, say, by issuance of additional shares does not? Accordingly, one must view as sound the idea expressed in the 1953 New York statutory provision denying appraisal rights to shareholders of the surviving corporation in a consolidation (merger) when that event does not make the kind of fundamental changes in the dissenter's shares that would give him appraisal rights under a charter amendment.[177] Further reconsideration might indicate that appraisal rights should be made to turn less on the shareholder finding himself in a different legal entity or in an expanded enterprise than on being drastically changed with respect to participation in earnings, liquidation, and control. It might also indicate that appraisal rights in a sale-of-assets situation should be granted in, and only in, a sale of assets for *securities* of the purchaser corporation, as one recent statute has provided,[178] rather than be denied in all sales, as is the case in most jurisdictions, or be granted even in sales for cash, as appears to be the case in some others. Sale of all of a corporation's assets for the purchaser's stock is, realistically, closer to a real merger of enterprises than are some "mergers" between affiliated companies.

5. *Required notice to shareholders of appraisal rights*

The new North Carolina statute requires that when shareholders are asked to vote on specified fundamental changes which give rise to dissenters' rights of appraisal—certain charter amendments, mergers, consolidations, etc.—they must be notified of these rights.[179] This idea is new in state corporation law, although it has been a familiar feature of the Securities Exchange Act of 1934 and regulations thereunder.[180] Amendments in 1957 to the Pennsylvania statute reflect the same policy.[181] Wisely or not, however, the North Carolina legislation expressly states that failure to include the notice does not invalidate the transaction in question, but gives the shareholder, unless he voted for the transaction, a year within which to make demand on the corporation for such damages as he may have suffered from his failure to receive notice. It remains to be seen whether North Carolina corporations will omit the notice and take their chances; the Pennsylvania lawyer, faced with statutory silence on the effect of failure to give notice, would be less inclined so to advise.

6. *Tie-in with SEC-supervised proxies*

The new Virginia statute permits a merger or consolidation to be approved by a majority of the shares of each class of shares, when the right to vote by classes exists, instead of by the "more than two-thirds" vote normally required, if the Securities and Exchange Commission "exercises jurisdiction over the proxy statement" for the pertinent shareholders' meeting.[182] The idea is a good one not only because SEC supervision affords some assurance that the shareholders are being

[177] N.Y. STOCK CORP. LAW § 87.
[178] N.C. GEN. STAT. § 55-113 (Supp. 1955).
[179] *Id.* §§ 55-100, 55-108, 55-112, 55-118.
[180] 17 C.F.R. § 240.14a-9, schedule 14A, item 2 (1949).
[181] PA. STAT. ANN. tit. 15, §§ 2852-311, 2852-902 (Supp. 1957).
[182] VA. CODE ANN. § 13.1-70 (Supp. 1956).

adequately informed of the matter under consideration, but also because, in the main, the publicly-held corporations within the federal proxy rules are the very ones in which it is sometimes difficult to get a two-thirds vote from the scattered and lethargic shareholders. For the latter reason, the Virginia statute might well have relaxed its requirement that, despite the majority vote of each class, there be approval of more than two-thirds of the total outstanding shares for a merger or consolidation. Incidentally, the thus permitted lower class vote for mergers and consolidations that fall within the SEC proxy regulations is not extended by the Virginia statute to charter amendments; however, it would be farfetched to see here a further occasion for resort to the *Havender* subterfuge for using the merger device to amend the charter.

7. *Sale of assets*

A relocation of a corporation's business is often accompanied by a change in the corporate entity as, say, by the formation of a new corporation—perhaps in another state—and the transfer of its assets to the new corporation for securities of the latter. Such a transaction is within the literal language of those statutes that give appraisal rights to dissenters on a sale of assets, but hardly within their spirit.[183] Accordingly, a 1957 Pennsylvania statutory provision quite logically exempts a sale of assets made for the purpose of relocating the business from the necessity of either a shareholders' vote or shareholders' appraisal rights.[184] The same end, with resultant out-of-state reincorporation, can be achieved by forming a subsidiary under the law of the new state and merging the parent into the subsidiary, if there exists a favorable combination of merger statutes—*i.e.*, the statutes of both states permitting merger with a foreign corporation, plus a statute of the parent state dispensing with appraisal rights in the case of a merger into a wholly-owned subsidiary. Of course, if the relocation sale of assets is accompanied by other fundamental changes in rights of shareholders, especially as between classes, the problem is not that simple.

The Model Act has given further impetus in recent state statutes to the now venerable Ilinois legislation with respect to the necessity for a shareholders' vote on a sale of all assets, differentiating between sales *in* and *out* of the ordinary course of business—a distinction reflected also in recent New York amendments and, although by a slightly different approach, in the new North Carolina statute.[185]

8. *Mergers with foreign corporations and with subsidiaries*

Since the California corporation statute revision of 1931, authorization for a domestic corporation to merge or consolidate with a foreign corporation enjoying

[183] As a series of New York cases have recognized. See Matter of Hake, 285 App. Div. 316, 136 N.Y.S.2d 817 (4th Dep't 1955); Petition of Avard, 144 N.Y.S.2d 204 (Sup. Ct. 1955); Rudel v. Eberhard Faber Pencil Co., 2 Misc. 957, 146 N.Y.S.2d 498 (Sup. Ct. 1955).

[184] PA. STAT. ANN. tit. 15, § 2852-311 (Supp. 1955).

[185] N.Y. STOCK CORP. LAW § 20; N.C. GEN. STAT. § 55-112 (Supp. 1955). *Cf.* MODEL BUSINESS CORPORATION ACT §§ 72-74.

similar authorization has become familiar. All recent statutory revisions have incorporated this feature.[186]

The comparatively ancient vintage of the New York short form of merger of a wholly-owned subsidiary into a parent corporation robs the revisions of the 1950's in that direction of complete novelty. The outstanding characteristics of this latter legislation are rather the simplification of procedures for such a merger—frequently, all that is needed is a resolution of the board of directors of the parent corporation, without a shareholders' vote[187]—and, perhaps even more important, the denial of dissenting shareholders' appraisal rights.[188] Even the standard longer form of merger under the Model Act and its followers, however, quite properly gives no appraisal right to dissenting shareholders of the surviving corporation which itself had held all the stock of the other constituent corporations, where the merger thus amounts to but a simple absorption of the subsidiaries.[189] A new wrinkle in this parent-subsidiary merger situation is introduced by section 68A of the Model Act's 1957 list of Revisions and Optional Sections, which permits employment of the short form of merger when the parent owns ninety-five per cent of the stock of the subsidiary, with appraisal rights for the dissenting shareholders of the subsidiary,[190] but not for those of the parent.

9. *Dissolution and newly-discovered assets*

One difficulty in corporation law long has been: What should be done with newly-discovered assets after purportedly complete liquidation and after the filing of the last papers that officially put an end to corporate existence? Statutes that prolong corporate life for two or three years for purposes of suit afford no satisfactory answer. The new North Carolina statute would recognize corporate life indefinitely, whenever necessary to administer newly-discovered assets: the corporation can sue in its name, acting through its last board of directors, however reduced in numbers, or through its last officers; and the thus still-vital corporation can re-establish its

[186] The list includes not only the states that have completely altered the basic patterns of their old corporation statutes, but many other states as well: California, District of Columbia, Florida, Illinois, Kentucky, Maryland, Michigan, Minnesota, Missouri, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Texas, Virginia, Wisconsin, and others.

[187] D.C. CODE ANN. § 29-927h (Supp. 1956); MD. ANN. CODE art. 23, § 63 (1951); N.D. Laws 1957, c. 102, § 72; OHIO REV. CODE ANN. § 1701.84 (Page Supp. 1956); VA. CODE ANN. § 13.1-76 (Supp. 1956); WIS. STAT. § 180.685 (1955).

[188] N.D. Laws 1957, c. 102, § 75; OHIO REV. CODE ANN. § 1701.84 (Page Supp. 1956); VA. CODE ANN. § 13.1-76 (Supp. 1956). Under D.C. CODE ANN. §§ 29-927n, 29-927i (Supp. 1956), the same result is apparently reached by requiring a dissenting stockholder to file his objection prior to or at the time of the shareholders' meeting, and in the short form of merger, *there is no meeting*. And in Maryland, the cash-to-dissenters statutory provision does not apply to shareholders of the surviving corporation unless the merger changes their contract rights—which need not be the case where wholly-owned subsidiaries are merged into the parent. MD. ANN. CODE art. 23, § 69 (1951).

[189] N.C. GEN. STAT. § 55-113(i) (Supp. 1955); N.D. Laws, c. 102, § 75; ORE. REV. STAT. § 57.490(6) (Supp. 1955); TEX. BUS. CORP. ACT art. 5.12-F (1956); WIS. STAT. § 180.69(6) (1955); *cf.* MODEL BUSINESS CORPORATION ACT § 71. The District of Columbia's new corporation statute, although modeled after the Model Act, omits this feature.

[190] The new North Dakota Business Corporation Act of 1957 follows this Model Act pattern. N.D. Laws 1957, c. 102, §§ 72, 75.

board and officers if it so desires.[191] A 1957 Pennsylvania statutory provision looks in the same direction.[192]

10. *Change in "entity" and abatement of criminal proceedings*

Statutes relating to merger, consolidation, and dissolution typically state that pending actions or proceedings by or against the corporation do not abate by virtue of the disappearance or death of the "entity" and that liabilities and obligations continue. Nevertheless, it is by no means clear whether a court will discover in the statutes a legislative intention that *criminal* proceedings and liability fall within the scope of this language.[193] If not, corporate death terminates criminal proceedings and liability. At least one of the new statutory revisions, however, makes it clear that *criminal* proceedings, as well as civil ones, are not terminated by dissolution or disappearance in a merger.[194]

11. *Restated multi-amendment charters*

To work with a charter that has gone through, say, a dozen amendments is an exasperating experience. Modern legislation has sought to meet the problem by expressly authorizing a charter amendment to consolidate the original charter and all prior amendments, plus any other contemporaneous amendments then also being made, into a restated charter. Although one such statute antedates the 1940's,[195] the late 1940's and 1950's is the period which has seen the most widespread adoption of this legislation.[196] In some jurisdictions, the point is handled briefly by simply including it in the list of expressly permitted charter amendments;[197] but a 1957 Illinois refinement requires the restated charter to be reproduced in full in the notice of meeting.[198] Many lawyers would probably advise such a notice in any event; but one still may speculate as to what is *the* restated charter if the shareholders believe that they are merely voting on the formality of consolidating the scattered terms of their existing charter and yet the restated charter as reproduced in the notice is different. Is the latter, then, only prima facie the restated charter? If so, why not let the directors restate the charter, with prima facie effectiveness? North Carolina so provides, with the alternative of a full-fledged amendment procedure, if that is the course chosen.[199]

[191] N.C. GEN. STAT. § 55-114 (Supp. 1955).

[192] PA. STAT. ANN. tit. 15, § 2852-1111 (Supp. 1957).

[193] *Cf.* United States v. Union Carbide and Carbon Corp., 230 F.2d 646 (10th Cir. 1956), *cert. denied,* 351 U.S. 939 (1956); United States v. Line Material Co., 202 F.2d 929 (6th Cir. 1953); United States v. Maryland State Licensed Beverage Ass'n, 138 F. Supp. 685 (D. Md. 1956).

[194] N.C. GEN. STAT. § 55-114 (Supp. 1955).

[195] OHIO REV. CODE ANN. § 1701.72 (Page Supp. 1956). Apparently even prior thereto, one or two states tacitly recognized restated charters by accepting them for filing and certification. P-H CORP. NEWS (Jan. 28, 1952).

[196] Thus, in this period: California, Colorado, Delaware, Illinois, Indiana, Maine, Maryland, New York, North Carolina, North Dakota, Texas, Virginia, and Wisconsin.

[197] *E.g.* VA. CODE ANN. § 13.1-56 (Supp. 1956); *cf.* N.C. GEN. STAT. § 55-105(e) (Supp. 1955).

[198] ILL. REV. STAT. c. 32, § 157.52 (1955), as amended, Ill. Laws 1957, S.B. 266.

[199] N.C. GEN. STAT. § 55-105 (Supp. 1955).

A recent Texas technical refinement[200] makes it clear that the text of the restated charter may include such changes as are then being additionally introduced, as distinguished from a mere consolidation text, and follows through with synchronizing technical elaborations. It is the kind of blueprint the office lawyer likes to see when he is working out a transaction, although one suspects that the bar manages satisfactorily under something less elaborate.[201]

In any case, authorization for a restated charter in the law of the state of incorporation does not necessarily do away with the customary requirements of submitting certified copies of the charter and *all* amendments (including this one!) when the corporation seeks official permission to do business in another state.

IX

FOREIGN CORPORATIONS

1. *Doings classified as not doing business*

A notable feature of the Model Act and of nearly all corporation statutes which have undergone radical revision since 1950 has been the inclusion of a formidable list of acts that are expressly stated therein *not* to constitute "doing business" locally by a foreign corporation.[202] The basic idea is not new. For a long time, some jurisdictions have expressly excluded purely interstate transactions, as to which there were, perhaps, constitutional doubts. Others have long excluded the making of local loans and the taking of local property as security or in payment of such loans,[203] or at least the taking of mortgages on local properties.[204] Still other scattered exclusions antedating the 1940's are local solicitations of orders through salesmen;[205] mail order transactions;[206] local installation of equipment by the outside seller corporation;[207] holding directors' or shareholders' meetings locally;[208] ownership of goods in local warehouses operated by residents or qualified corporations and local deliveries of those goods pursuant to out-of-state contracts;[209] voting the stock held by foreign corporations in local corporations and, in relation thereto, participation in management and control.[210] Sometimes, however, the exemption has still carried with it one consequence of "doing business": it has subjected the foreign corporation to local suits arising out of the activity in question.[211]

New additions, largely stemming from the Model Act, include: maintaining and defending suits and effecting settlements; maintaining bank accounts; maintaining

[200] TEX. BUS. CORP. ACT art. 4.07 (1956).
[201] *Cf.* VA. CODE ANN. §§ 13.1-55(p), and 13.1-56(c) (Supp. 1956).
[202] See Legislative Note, 32 WASH. L. REV. 204 (1957). *Cf.* MODEL BUSINESS CORPORATION ACT § 99.
[203] *E.g.*, ARIZ. REV. STAT. ANN. § 10-485 (1956); S.D. CODE § 11.2102 (1939); WIS. STAT. § 180.801 (1955).
[204] KAN. GEN. STAT. ANN. § 17-507 (1949).
[205] DEL. CODE ANN. tit. 8, § 343 (1953).
[206] *Ibid.*
[207] *Ibid;* OHIO REV. STAT. ANN. § 1703.02 (Page Supp. 1956).
[208] N.Y. GEN. CORP. LAW § 223 (in so far as concerns maintenance of suits based on such activities).
[209] TENN. CODE ANN. § 48-918 (1955).
[210] TEX. REV. CIV. STAT. art. 1533a (1948).
[211] *E.g.*, WIS. STAT. § 180.801 (1955).

stock transfer offices or agencies; effecting sales through independent contractors; and conducting isolated transactions.[212] Texas has recently added the exercising of powers of executors, administrators, or trustees with respect to a nonresident's estate, if the activities do not otherwise constitute doing business; it also has added investing, through out-of-state transactions, in Texas nonoperating mineral interests and doing various acts incidental to such ownership.[213] An occasional follower of the Model Act, too, goes beyond that Act in inducing foreign capital to invest locally without incurring full "doing business" legal risks, sometimes with limitations that have an eye on some measure of competitive protection of the local lending industry.[214]

2. *Expanded jurisdiction of local courts*

Even before the *International Shoe* case,[215] the legislatures of Maryland and Vermont apparently had concluded that local jurisdiction over a foreign corporation for the purposes of suit was justified as a legitimate interest of the local state in the protection of its residents, even though the corporation was not locally "doing business" under the constitutional law decisions, and so could not be viewed as being "present in the state" or as having "entered" the state and "consented" to suit under its laws.[216] The subjection of a foreign corporation to a local suit arising out of the local commission of a tort or the breach of a contract made or to be performed locally, to the damage of a local resident, was not deemed by those legislatures to be so arbitrary, capricious, oppressive, irrational, or whimsical as to violate the requirements of "due process." As was to be expected after the *International Shoe* case, with its apparent repudiation of the "doing business" test in favor of a "fairness and reason" test that would seem basic in any due process determination, courts upheld this legislation.[217] A novel 1955 North Carolina statutory provision went even further: It apparently operated on the theory that if a company enjoys the benefits of a local market for its product, one of the headaches that not unreasonably can be linked to that benefit is subjection to local suits in favor of local residents damaged by that product. Accordingly, it provided, in addition to the local tort and contract features, comparable to those of the Maryland and Vermont statutes, that local jurisdiction in favor of local interests could be asserted in an action against a foreign corporation that grew out of the production, manufacture, or distribution of goods by the foreign corporation with the expectation that the goods were to be used in North Carolina, regardless of how or where produced or marketed.[218] This,

[212] *E.g.*, Tex. Laws 1957, c. 54, § 4, amending TEX. BUS. CORP. ACT art. 8.01 (1956).

[213] *Ibid.*

[214] See N.C. GEN. STAT. § 55-131(b)(6) (Supp. 1955); TEX. BUS. CORP. ACT art. 8.01(12) and (13) (1956).

[215] International Shoe Co. v. Washington, 326 U.S. 310 (1945).

[216] MD. ANN. CODE art. 23, § 88(d) (1951); VT. STAT. § 1562 (1947).

[217] Johns v. Bay State Abrasive Products Co., 89 F. Supp. 654 (D. Md. 1950); Compania de Astral, S.A. v. Boston Metals Co., 205 Md. 237, 107 A.2d 357 (1954); Smyth v. Twin State Improvement Corp., 116 Vt. 569, 80 A.2d 664 (1951).

[218] N.C. GEN. STAT. § 55-38.1 (Supp. 1955) (this particular feature of the new corporation statute was not postponed in effectiveness until July 1, 1957, as was the rest of that statute).

however, apparently went too far for the jurisdictional "due process" outlook of the courts that have considered it, at least as applied to the cases before them.[219] Another paragraph of this same enactment would base local jurisdiction on repeated solicitations of local orders by mail or otherwise, and it remains to be seen whether this, as well, is too much for the prevailing judicial notions of due process.

Another innovative feature of the recent North Carolina legislation in this area is this: It would subject a foreign parent corporation to local suit through service of process on its local subsidiary corporation, but only in those situations where the parent itself is liable for the subsidiary's obligation.[220] For example, the parent's liability might arise from the thinness of the equity capital of the subsidiary or from directing the subsidiary's patent infringements or other torts.[221] Maintenance of local suits against a foreign parent on causes of action so limited is not without judicial precedent.[222] (This is not to be confused, however, with the broader and more dubious proposition that a foreign corporation is doing business locally if its subsidiary, especially a wholly-owned subsidiary, operates locally[223]—although it is by no means certain that a statute could not go even that far,[224] at least as applied to causes of action in favor of local residents growing out of local activities of the subsidiary.) If a court were to follow a purely mechanistic separate-entity theory of corporations and narrowly interpret the *International Shoe* case, it could, of course, pronounce this provision unconstitutional on the ground that it is the subsidiary, not the parent, which

[219] Erlanger Mills, Inc. v. Cohoes Fibre Mills, 239 F.2d 502 (4th Cir. 1956); Putman v. Triangle Publications, Inc., 245 N.C. 432, 96 S.E.2d 445 (1957). See also Walker v. Ballantine & Sons, 149 F. Supp. 379 (M.D. N.C. 1957). There is something to be said for the decision in the *Erlanger* case, since the defendant manufacturer had done nothing to cultivate the North Carolina market; he simply had sold in New York to a customer who came in to buy. The *Triangle* and *Ballantine* cases, however, involved defendants who were systematically cultivating that market. The *Triangle* case becomes even more questionable when viewed in the light of a recent Supreme Court decision. McGee v. International Life Ins. Co., 355 U.S. 220 (1957); Note, 7 DUKE L.J. 135, 139 n. 26 (1958).

The aftermath of this is interesting. Because of these adverse decisions, the General Statutes Commission moved to delete the constitutionally-offensive section, and one of its members, who was at the time serving in the legislature, introduced a bill to that end. The Judiciary Committee of the Senate, however, which is largely composed of lawyers, opposed the bill on the ground that the provision, despite judicial hostility thereto, was a *good* one and might still win favorable recognition in the courts. (Reported orally to the writer by one of the members of the Committee.) Thus, the courts appear to be at odds with (one may reasonably infer) the lawyers of North Carolina.

Judge Sobeloff, who wrote the opinion in the *Erlanger* case, rationalizes his position again in *Jurisdiction of State Courts over Non-Residents in Our Federal System*, 43 CORNELL L. Q. 196 (1957). For what appears to this writer's perhaps biased vision a successful rebuttal, see Cardozo, *The Reach of the Legislature and the Grasp of Jurisdiction*, *id.* at 210.

[220] N.C. GEN. STAT. § 55-38.1(b) (Supp. 1955).

[221] See, *e.g.*, Certain-Teed Products Corp. v. Wallinger, 89 F.2d 427, 436 (4th Cir. 1937).

[222] Industrial Research Corp. v. General Motors Corp., 29 F.2d 263 (N.D. Ohio 1928). *Cf.* Mazzotti v. Rainey, 31 Del. Ch. 447, 77 A.2d 67 (Ch. 1950), critically analyzed in Note, 60 YALE L.J. 908 (1951).

[223] See Cannon Mfg. Co. v. Cudahy Packing Co., 267 U.S. 333 (1925).

[224] *Id.* at 336: "The claim that jurisdiction exists is not rested upon the provisions of any state statute. . . ." Consider the implication of Berkman v. Ann Lewis Shops, 246 F.2d 44 (2d Cir. 1957), for the validity of a statute that would clearly show an intention to view local business of a wholly-owned subsidiary as amounting to "doing business" by the parent corporation, at least for purposes of local suits on locally-arising causes of action.

has the "contacts" within the state. But it would be somewhat paradoxical to hold a foreign corporation not constitutionally amenable to local suit on its liability for the obligations of its wholly-owned local subsidiary and yet hold it subject to local jurisdiction through, say, the activities of a controlled "independent dealer" outlet.[225]

3. *Internal affairs*

A further North Carolina novelty is a statutory provision that actions against foreign corporations are not to be dismissed simply because they involve "internal affairs," but that dismissal must rather turn on considerations of *forum non conveniens*.[226] Aside from the fact that this probably reflects the unarticulated basis of most of the "internal affairs cases," one must not overlook the fact that foreign corporations are frequently local in character.[227]

4. *Choice of law*

One may speculate as to the purpose behind the unique 1952 Georgia enactment that the law of the state of incorporation of a domesticated foreign corporation shall govern the voting and other conditions of corporate action, the effectiveness of charter amendments, and all rights between the corporation and its shareholders and among the shareholders and the classes of shareholders.[228] Offhand, it looks like a restatement of some orthodox principles of the conflict of laws. Perhaps it was simply meant to offset the other quite common statement that is found in the Georgia corporation statutes that shareholders of domesticated foreign corporations are subject to the same obligations, duties, liabilities, and disabilities as shareholders in local corporations.[229]

Speaking of the conflict of laws, one may also speculate as to the effect of the recent Texas variations of the Model Act with respect to the officers and directors of foreign corporations. Whereas the Model Act provides that nothing in the Act is to be construed to permit the local state to regulate the "organization or the internal affairs" of a foreign corporation authorized to transact business locally,[230] the Texas counterpart refers to "the organization of such corporation, or its internal affairs *not intrastate in Texas*";[231] and a contemporaneous Texas variant subjects the officers and directors of such a foreign corporation to the same "duties, restrictions, penalties, and liabilities" as the officers and directors of Texas corporations.[232] Query: Can these variants be construed to mean, for example, that if the directors of the foreign corporations hold their meeting in Texas and have the corporation pay a dividend in Texas that would be unlawful for a Texas corporation, they may be subject to liability, regardless of the lawfulness of the dividend in the state of incorporation? Or did this legislation have in mind primarily the pseudo-foreign corporation?

[225] Kahn v. Maico Co., 216 F.2d 233 (4th Cir. 1954); Thomas v. Hudson Sales Corp., 204 Md. 450, 105 A.2d 225 (1954); McNeil v. Electric Storage Battery Co., 109 S.C. 326, 96 S.E. 134 (1918). *Cf.* S. B. MacMaster, Inc. v. Chevrolet Motor Co., 3 F.2d 469 (E.D. S.C. 1925).

[226] N.C. GEN. STAT. § 55-133 (Supp. 1956). *Cf.* Note, 97 U. PA. L. REV. 666 (1949).

[227] See Latty, *Pseudo-Foreign Corporations*, 65 YALE L.J. 137 (1955).

[228] GA. CODE ANN. § 22-1601 (Supp. 1955).

[229] GA. CODE § 22-1601 (1936).

[230] MODEL BUSINESS CORPORATION ACT § 99.

[231] TEX. BUS. CORP. ACT art. 8.01 (1956).

[232] *Id.* art. 8.02.

(Particularly in a pseudo-foreign corporation, otherwise completely Texan, can there quite readily be "internal affairs" that are, nevertheless, "intrastate" in Texas?)

5. *The local agent*

A new twist with respect to service-of-process agents of foreign corporations appears in the new Virginia statute, which requires such an agent to be either a member of the Virginia bar or an officer or director of the foreign corporation.[233] The aim of this provision is not hard to discern, but it offers no stumbling block to those organizations that make a business of serving as statutory local agents of foreign corporations: all they need do is persuade the foreign corporation to make some person in the organization's Richmond office an assistant secretary of the corporation—which, in fact, is actually the current practice.[234] A 1955 Kansas statutory provision with somewhat similar objectives requires the statutory local agent to be either a local resident individual or a domestic corporation.[235] Again, the nationally-operating service organizations have merely formed wholly-owned domestic subsidiary corporations to act as statutory local agents.

6. *Revocation of authority*

Most statutes that specifically deal with the revocation for stated causes of a foreign corporation's authority to do business in the state place the power in administrative hands—usually the secretary of state. For reasons no doubt political in nature, rumors of which have even been heard *in partibus infidelium,* the recent Texas statute requires the revocation to be effected by the decree of a court.[236]

7. *Charter-filing requirement*

By a New York statutory amendment in 1954 and a Pennsylvania statutory amendment in 1957, a foreign corporation need not file in those states a copy of its charter as a prerequisite to permission to transact business there.[237] This dispensed-with formality, which has long been traditional in every other state[238] and which can be something of a nuisance for a corporation with an often-amended charter, probably serves no useful practical purpose, despite theoretical arguments to the contrary, and this break with the past is probably justified.

Aside from the features above noted and some minor details,[239] there is little else in the recent corporation statutes which, with respect to foreign corporations, is unfamiliar, if for no other reason than that many of the new statutes are simply lineal descendants, in this regard, of the Illinois Business Corporation Act of 1933.

[233] VA. CODE ANN. § 13.1-109 (Supp. 1956).

[234] Letters to the writer from New York headquarters of several such organizations.

[235] KAN. GEN. STAT. ANN. § 17-4401 (Supp. 1955).

[236] TEX. BUS. CORP. ACT art. 8.16 (1956).

[237] N.Y. GEN. CORP. LAW § 210; PA. STAT. ANN. tit. 15, § 2852-1004 (Supp. 1956).

statements of more vital significance than those usually required in other states.

[238] Except New Hampshire, which has long been unique in imposing no such requirement, apparently with no bad effects.

[239] *E.g.,* Tex. Laws 1957, c. 54, § 12, requiring in the application for withdrawal from the state statements of more vital significance than those usually required in other states.

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